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edited by

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Table of Contents

TABLE OF CONTRIBUTORS vii

INTRODUCTION

by Robert H. Mundheim 1

Chapter I. FOREIGN BANKS IN THE UNITED STATES: Acquisitions, Branching, and Other Techniques

by Dennis J. Lehr and Cameron F. MacRae III. 4

1. OPTIONS AVAILABLE TO FOREIGN BANKS 4

A. Before the International Banking Act 4

(i) Lack of national policy 4

(ii) Competitive inequality 4

(iii) Options 5

B. The International Banking Act of 1978. . . . 5

(i) Current options. 6

(ii) Federal controls 6

(iii) Types of offices 7

(iv) Edge Act branches 7

(v) Obstacles to Edge Act branching 8

2. RESTRICTIONS ON FOREIGN BANKS 9

A. Restrictions on Entry 9

(i) Exceptions to the general rules 9

(ii) Home state rules 9

(iii) Three sets of rules 10

B. Non-Banking Activities. 10

(i) Securities 11

(ii) Manufacturing 11

(iii) Compromises 11

C. Dual Banking System Problems. 12

3. DIRECT ACQUISITION OF EXISTING BANKS. 13

A. Antitrust Law in Banking 13

(i) Anti-competitive effects. 13

(ii) Future trends 14

B. Acquisition Techniques. 15

C. Controlling Foreign Acquisitions 16

(i) Edge Act corporations. 16

(ii) Non-banking activities 16

D. Objections to Foreign Acquisitions. 16

NOTES 20

APPENDIX I: International Banking Act of 1978: A Selected Bibliography 22

Published by Penn Law: Legal Scholarship Repository, 2014

Chapter II. Supervising Multinational Banking Organizations: RESPONSIBILITIES OF THE HOST COUNTRY

by Neal L. Peterson 27

1. PRINCIPLES OF SUPERVISION 27

2. THE SUPERVISORY FORMS. 28
   - A. The Proposed Forms 28
   - B. Comments on the Forms 28
   - C. Final Version of the Forms 29

3. SOLVING THE CONFIDENTIALITY PROBLEM: THE NEW F.R. 2068 30

NOTES 31

APPENDIX II-A: Federal Reserve System Report Requirements (F.R. Y-7 and F.R. 2068). 32

APPENDIX II-B: Federal Reserve System Report Requirement (F.R. Y-8f) 37

Chapter III. Supervising Multinational Banking Organizations: RESPONSIBILITIES OF THE HOME COUNTRY

by Alain Hirsch 40

1. RESPONDING TO THE DEMANDS OF THE HOST COUNTRY. . . 40
   - A. U.S. Requirements 40
   - B. Criticisms of the New U.S. Requirements . . . 41

2. HOME COUNTRY SUPERVISORY RESPONSIBILITIES 41

3. NEED FOR MULTINATIONAL COOPERATION 43

Chapter IV. Supervising Multinational Banking Organizations: EVOLVING TECHNIQUES FOR COOPERATION AMONG SUPERVISORY AUTHORITIES

by W. Peter Cooke. 46

1. RECONCILING DIFFERENT LEGAL SYSTEMS 46
   - A. Domestic Supervision 46
   - B. Steps toward Global Supervision. 47

2. THE BASLE COMMITTEE OF SUPERVISORS 47
   - A. The Concordat. 48
   - B. The Principle of Consolidation 49

3. SHARING INFORMATION 49

4. FUTURE TRENDS 50

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

5. REMAINING PROBLEMS 51

NOTES 54

APPENDIX IV: Developments in Cooperation Among Banking Supervisory Authorities. 55

Chapter V. INFLUENCE OF INTERNATIONAL BANKING ON BANK REGULATION IN THE UNITED STATES

by Robert Carswell. 65

1. HISTORICAL PERSPECTIVE 65

2. DEVELOPING POLICY AREAS 66

A. Monetary Policy 66
(i) Reserve requirements 66
(ii) Eurodollar markets. 67
(iii) Inflation curbs. 67
(iv) Future trends 68

B. Standards for Judging Foreign Bank Acquisitions 68
(i) 1980 Moratorium on acquisitions 68
(ii) Extraordinary Assistance Bill 68
(iii) Possible tests 69

C. Equality of Competition Between U.S. and Foreign Banks 69
(i) Geographical limitations. 69
(ii) Non-banking activities 70
(iii) Funding costs 70
(iv) Export trading 70
(v) Future trends 71

Chapter VI. Lessons from the Iranian Experience: NATIONAL CURRENCIES AS INTERNATIONAL MONEY

by John E. Hoffman, Jr. and Ian H. Giddy . . . 73

1. THE IRANIAN EXPERIENCE 73

A. Imposition of the Freeze 73

B. Attack on the Freeze Outside the United States. 74

C. Defense of the Freeze 74

2. EURODOLLARS AND THE INTERNATIONAL PAYMENT SYSTEM. . 75

A. Nature of Eurodollars 75

B. Risks of Holding Eurodollar Deposits 76

C. International Dollar Payments System 77

D. CHIPS 80

3. EFFECTS OF THE FREEZE. 82

A. Deposits with U.S. Banks Abroad. 82

B. Application of the Freeze to Cover and Foreign Currency Accounts. 83

Published by Penn Law: Legal Scholarship Repository, 2014

C. Alternative Payment Systems 85
D. Foreign Currency Accounts. 86

NOTES 88

Chapter VII. Lessons from the Iranian Experience: IMPACT ON LOAN SYNDICATIONS AND OTHER INTERNATIONAL TRANSACTIONS

by Bruce W. Nichols 89

1. IMPORTANCE OF LOAN DOCUMENTATION 89

2. AREAS OF REEXAMINATION 90
A. Central Bank Guarantees 90
B. Jurisdictional Clauses. 91
C. Event of Default. 91
D. Remedy Clauses 92
E. Control of Acceleration Rights 92
F. Sharing Provisions 93
G. Agents' Authority 93

3. DEPOSIT DOCUMENTATION. 94

4. POLITICAL RISK 95

APPENDIX VII: Excerpts from Specific Documents . . . 96

Chapter VIII. FOREIGN COMPANIES RAISING CAPITAL IN THE UNITED STATES

by Michael H. Coles 102

1. INTERNATIONAL SECURITIES MARKETS 102

2. HISTORICAL PERSPECTIVE 102
A. Development of the Yankee Bond Market. 102
B. The Current Yankee Bond Market 104
C. Changes and Improvements 105

3. ADVANTAGES TO THE ISSUER OF THE YANKEE BOND MARKET . 106
A. Characteristics of the Market 106
B. Characteristics of the Issues 107
C. Characteristics of the Investors 108

4. REGISTRATION REQUIREMENTS 109
A. Governmental Issuers 109
B. Corporate Issuers 110

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

C. Problems 110
(i) *Accounting* 110
(ii) *Segment accounting*. 110
(iii) *Executive compensation* 110
(iv) *Disclosure of foreign payments*. 111
(v) *Proposals for change* 111

5. YANKEE EQUITIES. 112
A. Characteristics of the Market 112
B. Tricentrol: A Case History 113

6. OTHER MARKETS 115
A. Commercial Paper. 116
B. Private-Placement Market 117

7. DISCLOSURE STANDARDS FOR FOREIGNERS 118

NOTES 121

Chapter IX. UNITED STATES COMPANIES RAISING CAPITAL ABROAD

by Michael von Clemm 122

1. FINANCING CAPITAL SPENDING 122
A. Timing and Cost 122
B. Answers to the Dilemma. 123
(i) *Domestic credit lines*. 123
(ii) *Alternative markets* 123
C. Transnational Financing 124

2. THE INTERNATIONAL MARKET. 125
A. The Relationship Between U.S. Markets and Euro-Markets 125
B. Leadership of the International Market . . . 126
C. Access to the International Market. 127
(i) *Role of the universal banks*. 127
(ii) *Cost of international funding* 128
(iii) *Criteria for participation* 129

Chapter X. RESTRICTIONS ON FOREIGN INVESTMENT: DEVELOPMENTS IN UNITED STATES LAW

by David W. Heleniak 132

1. TRADITIONAL POLICY OF LIBERALISM 132
A. Foundations of the Open Door. 133
B. The Power to Regulate 133
C. Exceptions to the Open-door Policy. 133
(i) *Federal restrictions in particular industries*. 133
(ii) *Restrictions on real property ownership*. . 135

Published by Penn Law: Legal Scholarship Repository, 2014

2. POLITICAL CONCERN OVER FOREIGN INVESTMENT 136

3. RESTRICTIONS ON FOREIGN INVESTMENT 136

A. Reporting Requirements. 137

B. New and Proposed Legislation. 138

(i) Banking 138

(ii) Real estate 139

(iii) Margin requirements 139

APPENDIX X: A Selected Bibliography 140

Chapter XI. RESTRICTIONS ON FOREIGN INVESTMENT: DEVELOPMENTS IN EUROPEAN LAW

by André Bruyneel 141

1. INTRODUCTION. 141

2. INTERNATIONAL AND EEC INFLUENCES 142

A. OECD Rules. 142

B. EEC Law. 143

(i) Freedom of establishment. 143

(ii) Free movement of capital. 144

3. RESTRICTIONS ON FOREIGN DIRECT INVESTMENT 145

4. DEVELOPMENT AND EFFECTIVENESS OF RESTRICTIONS. . . 146

A. Developments 146

B. Effectiveness. 146

5. RESTRICTIONS ON FOREIGN INVESTMENT IN BANKS . . . 147

A. Within the EEC 147

B. Restrictions in Non-EEC Countries 148

NOTES 149

Chapter XII. RESTRICTIONS ON FOREIGN INVESTMENT: DEVELOPMENTS IN JAPANESE LAW

by Misao Tatsuta 159

1. EXCLUSIONARY LAW AND ITS DEMISE 159

2. ACQUISITION OF SHARES BY ALIENS 160

A. Portfolio Investment 160

B. Direct Domestic Investment 160

C. Acquisition of Controlling Ownership 161

3. OBSTACLES TO A TAKEOVER 161

A. Tender Offer Legislation 162

B. Stock Exchange Reporting Requirements. . . . 162

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

C. Cumulative Voting 162
D. Qualification of Directors 162

4. ADMINISTRATIVE GUIDANCE 163

5. FUTURE POTENTIAL 163

NOTES 164

APPENDIX XII: Foreign Exchange and Foreign Trade Control Law (Japan) 169

Chapter XIII. DEVELOPMENTS IN HARMONIZATION OF ACCOUNTING STANDARDS

by LeRoy J. Herbert 175

1. HARMONIZATION 175

2. THE EUROPEAN ECONOMIC COMMUNITY 176

3. INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE . . . 176

4. FOREIGN CURRENCY TRANSLATION 178

5. THE INTERNATIONAL ACCOUNTING FIRMS 179

APPENDIX XIII-A: Organizations Active in Setting International Accounting Standards. . 181

APPENDIX XIII-B: Summary of Statements of International Accounting Standards and Exposure Drafts Issued by the IASC as of January 1, 1981 183

APPENDIX XIII-C: Comparison of International Accounting Standards with Accounting Rules and Principles Applicable in Certain Major Practice Areas Around the World. . . 184

Chapter XIV. INTERNATIONAL SECURITIES MARKETS: COMPARATIVE DISCLOSURE REQUIREMENTS

by Robert C. Pozen. 194

1. RECENT HARMONIZATION INITIATIVES IN THE U.S. . . . 194
A. SEC Form 20-F. 194
B. 1933 Act Disclosure. 195
C. Shelf Registration 196

2. INCREASE IN DISCLOSURE STANDARDS ABROAD. 196
A. Sixth Directive of the EEC 196
B. Proposed EEC Directive on Disclosures to Employees 196

Published by Penn Law: Legal Scholarship Repository, 2014

C. Minimum Standards 197
D. World Class Securities. 197

NOTES 198

APPENDIX XIV-A: Comparison of Substantive Provisions of SEC Form 20-F and the EEC's Sixth Directive, Annexes A (Shares) and B (Debt) . 199

APPENDIX XIV-B: Outline of Current Disclosure Issues . 209

APPENDIX XIV-C: EEC Proposal for a Directive on Procedures for Informing and Consulting the Employees of Undertakings with Complex Structures, in Particular Transnational Undertakings 218

Chapter XV. SPECIAL PROBLEMS ARISING AS A RESULT OF TRADING IN MULTIPLE MARKETS

by Charles M. Nathan. 225

1. BARRIERS TO ENTRY INTO THE U.S. SECURITIES MARKETS . 225

2. THE SECURITIES ACT OF 1933 AND U.S. SECURITIES ISSUED ABROAD. 225
A. Jurisdictional Scope 225
B. SEC Release No. 4708 226
C. The Ninety Day Lock-up. 227
D. Equity Issues. 228

3. FOREIGN ISSUERS IN THE U.S. MARKETS 230
A. Flow-back 230
B. Disclosure. 231
(i) 20-F registration 231
(ii) Viewpoint of foreign issuers 232
(iii) Psychological barriers 233

4. SECONDARY MARKET TRADING IN FOREIGN SECURITIES . . 234
A. Effects of the 1933 Act 234
B. The Seasoning Rule 235

NOTES 235

APPENDIX XV: Outline of Rules Applicable to Foreign Market Trading and Euro-securities . . . 236

Chapter XVI. CONSTRAINTS ON BROKER-DEALERS OPERATING OUTSIDE THEIR HOME COUNTRY

by Richard N. Miles 260

1. BROKER-DEALERS OPERATING ABROAD 260

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

A. Which Broker-Dealers? 260
B. Operating Where?. 262
(i) Initial entry techniques. 262
(ii) U.S. neighbors 263
C. What Kinds of Activities?. 263

2. THE REPRESENTATIVE OFFICE 264
A. Tax Arrangements. 264
B. Activities Not Triggering Regulatory Controls . 265
C. Home Country Constraints 266

3. THE GROWTH OF SOME INTERNATIONAL MARKETS 266
A. The Equity Market 266
B. The Money Market. 267
C. An Around-the-Clock Market 267

APPENDIX XVI: Restrictions Imposed in Specific Countries 270

Chapter XVII. REGULATION OF INTERNATIONAL SECURITIES MARKETS: TOWARDS A GREATER COOPERATION

by Harold M. Williams and Lee B. Spencer, Jr. . 279

1. THE INTERNATIONAL CHARACTER OF THE SECURITIES MARKETS. 279

2. IMPLICATIONS FOR REGULATORS. 280
A. Regulatory Disparities. 280
B. Disclosure Standards 281
C. Rights Offerings. 281
D. Acquisitions 282
E. Equal Access 282
F. Supervision 282

3. POTENTIAL REGULATORY RESPONSES. 283
A. Competition 283
B. Cooperation 284

4. A PROPOSED INTERNATIONAL COMMITTEE OF SECURITIES REGULATORS. 284
A. Organization 284
B. Advantages. 285
C. Potential Problems 285

5. CONCLUSION 285

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Chapter XVIII. SECRECY LAWS AND OTHER OBSTACLES TO INTERNATIONAL COOPERATION

by T. Peter Lee, Marie-Claude Robert, Alain Hirsch, and Irving M. Pollack . . . 287

1. A BRITISH POINT OF VIEW 287
   A. Discovering Beneficial Owners 287
   B. Extra-Territorial Reach 288

2. A FRENCH POINT OF VIEW 290
   A. Secrecy Laws as an Obstacle to Effective Supervision. 291
      (i) COB experience with secrecy laws in foreign countries 291
      (ii) The new French secrecy provisions. . . . 293
   B. Future Directions in International Cooperation. 294
      (i) Formal cooperation. 294
      (ii) Informal cooperation 295

3. A SWISS POINT OF VIEW. 297
   A. Harmonization in the Securities Field. . . . 297
   B. The Swiss Banking Agreement 299

4. AN AMERICAN POINT OF VIEW 300
   A. The IOS Problem 301
   B. International Cooperation in the IOS Case . . 303

NOTES 305

APPENDIX XVIII-A: Swiss Agreement on the Observance of Care in Accepting Funds and on the Practicing of Banking Secrecy . . . 308

APPENDIX XVIII-B: Commentaries on the Swiss Banking Agreement. 312

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

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INTRODUCTION

Robert H. Mundheim

MR. MUNDHEIM: Nowhere is it clearer that we live in an international context than in the world of finance, money, and capital markets. Nevertheless, important national interests are expressed in the regulatory and other structures that, at least at times, impede the free flow of capital and the development of institutions to serve the needs of the capital markets.

There are a number of examples of efforts to create international forums to discuss the ways in which to accommodate the differing goals of free capital markets and appropriate regulatory schemes. For example, the New York Stock Exchange is an active participant in the International Federation of Stock Exchanges which has taken some steps to harmonize the activities of exchange markets for stocks and bonds. The University of Pennsylvania Center for Study of Financial Institutions was the catalyst some years ago for organizing a standing International Faculty for Corporate and Capital Market Law comprised of academics from seven countries. All of the members of that faculty are here today and will be participating in the plenary sessions and in the workshops [1].

Today's conference represents a joint effort by the New York Stock Exchange and the Center for Study of Financial Institutions along with the American Law Institute to promote what we hope will be a wide-ranging discussion among a diverse group of participants.

The focus of today's discussion is banking. After a brief look at the rush of foreign banks to the U.S., we will turn to the views of regulators from three of the leading banking countries on key issues relating to the supervision of multinational banking organizations. In particular, we will discuss the division of responsibility between the supervisory authorities of the host country and home country. In addition, the role of international cooperation among regulatory authorities will be canvassed. Significant multinational activity requires a somewhat different regulatory response than purely domestic activity and you will see that point illustrated in this morning's discussion.

Further, this morning's discussion will foreshadow later discussions of the regulatory problems associated with the multinational activities of securities firms and one of the points that the conference will develop is that what is happening in the banking field now will likely be followed, at least in certain respects, in terms of approach and techniques in the securities business.

After the discussion of the supervisory problems, we will focus on the U.S. scene to see how the activities of foreign banks in the U.S. and how the development of international banking have influenced and may in the future influence various aspects of domestic bank regulation and practice.

This afternoon we will shift our emphasis from the institution of banking to banks' stock in trade, money. That discussion will take off from the dramatic U.S. freeze of Iranian assets. What impact does that experience have on the willingness of foreigners to hold dollars in U.S. banks in the U.S. or in their branches or sub-

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sidiaries abroad? Will it spur the development of a dollar clearing system outside the U.S.? The Iranian experience has also caused a re-examination of syndicate loan practices and we will also get an analysis of some of those practices.

NOTES

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From its inception, the International Faculty has worked particularly closely with the Japan Securities Research Institute, Instituto Brasileiro de Mercado de Capitais (IBMEC) and the French Commission des Operations de Bourse. Dr. Kaichi Shimura, Dr. Nelson L. Eizirik and Madame Marie-Claude Robert are Associate Members representing these institutions.

The International Faculty has also worked closely with Carl W. Schneider, Visiting Professor, University of Pennsylvania Law School and the Acting Director of its Center for Study of Financial Institutions; Dr. Alain Viandier of the Faculty of Sciences and Economics, Caen, France; Professor Yoshio Kumano of Senshu University; Claude Lempereur, Conseiller of the Belgium Banking Commission; and André Bruyneel, Avocat and Law Professor at the University of Brussels.

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FOREIGN BANKS IN THE UNITED STATES:
Acquisitions, Branching, and Other Techniques

Dennis J. Lehr and Cameron F. MacRae III

MR. MUNDHEIM: The first subject that we want to discuss relates to the entry of foreign banks into the U.S. Dennis Lehr will start us off on that subject.

1. OPTIONS AVAILABLE TO FOREIGN BANKS

MR. LEHR: My presentation will focus heavily on certain statutory terms whose interpretation is essential and whose history is not as clear as one might hope. The most interesting issues relate to what Congress meant when it propounded the doctrine that we have come to call "national treatment" or "parity of treatment". Simple words like "prohibited" are now very actively being considered in the courts. I mention this because such questions will form the backdrop of the first three speakers--myself, Cam MacRae, and Neal Petersen--who will try to cover for you, perhaps with a bit of overlap, some of the key provisions of the International Banking Act [hereinafter IBA] [1]. Some of the Act's most important questions center around the meanings of its terms.

A. Before the International Banking Act

(i) Lack of national policy

Before we get right into the analysis of statutory terms, let us back up a little and talk about these concepts of "national treatment" and "parity of treatment". The Senate report on the IBA advanced the proposition that, unlike many other forms of foreign enterprise doing business in the U.S., foreign banks operating in this country were not subject to a uniform national policy. This, in fact, was true because except for those that were federally chartered--*i.e.*, national bank subsidiaries--foreign banking organizations in this country were subject only to state law. This, it was felt, produced several undesirable consequences.

First, there was a lack of uniform national policy which hampered government efforts in the area of economic and monetary policy. Many foreign deposit-taking operations were not, for example, subject to federally imposed reserve requirements. Consequently, the Fed argued for years that this hampered its ability to control the money supply and, in turn, its fight to control inflation.

(ii) Competitive inequality

Second, foreign banks often enjoyed, it was felt, competitive advantages over federally chartered domestic counterparts. The most notable example of this was the inapplicability of the restrictions on multiple state branching that apply to U.S. banks.

At this point, let me interrupt myself and mention two names, as a shorthand, because we are going to be talking about them later. When we use the expression, "the McFadden Act", we refer to that part of U.S. banking law that restricts domestic banks from branching

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across state lines. The "Douglas amendment" to the Bank Holding Company Act has a similar effect and prohibits holding companies that are presently operating in one state from acquiring subsidiary banks in another state [2]. But to continue . . . .

These concerns over the competitive inequality between foreign and domestic banks operating in this country obviously underlie the concept of parity of treatment and national treatment. The considerations involving parity of treatment fostered those provisions of the IBA that now restrict certain interstate expansion opportunities of foreign banks and subject them to reserve requirements, impose Bank Holding Company Act type restrictions on their non-bank activities, and subject many of them to the examination, asset maintenance, reporting, and other obligations to which national banks are subject.

Less widely known is the fact that the notion of parity of treatment has also been applied to eliminate or modify statutory provisions which were considered to be unfair to foreign banks in their efforts to compete fairly with domestic institutions. For example--and we will hear more of this later--foreign banks may now acquire a majority stock interest in an Edge Act corporation and establish U.S. as well as foreign branches of such Edge Act corporations.

(iii) Options

Again, to help us analyze the thrust of the IBA, let me state briefly the ground rules applicable to foreign banks prior to the passage of the IBA. Foreign banking institutions were then conducting their U.S. operations in one of three forms only: (1) A subsidiary bank could be established with a national charter or under state law; (2) They could establish a branch or an agency; or (3) They could operate by means of representative offices.

Subsidiaries and branches ordinarily enjoyed retail deposit-taking powers. The agencies, of course, could accept only so-called credit balances. For those who are not initiated, the simplest way to remember a credit balance is to recall that it is the kind of account that the holder cannot add to, e.g., by deposit of additional funds. They have been described as active balances that arise from or are incident to transactions involving loans, funds in transition, letters of credit, and other identifiable events.

Except in the case of federally chartered subsidiary banks--and there were not many subsidiaries owned by foreigners--the important issues of entry control, market expansion, and government supervision were solely the province of state law. Consequently, foreign banks were drawn to a handful of states--New York, Illinois, California--offering attractive banking opportunities and a hospitable legal environment. In addition, prior to the passage of the IBA, the non-banking activities of foreign bank holding companies were not subject at all to the U.S. Bank Holding Company Act.

B. The International Banking Act of 1978

Five different pieces of legislation were introduced in Congress during the 1960s to subject foreign banking to overall federal regulation, but none ever got out of committee. It was not until the mid-1970s, following the significant rise in foreign bank operations in the U.S., that there was serious demand for a rationalization of foreign bank supervision at the federal level. It was then that the idea of national treatment and parity of treatment emerged and--with a helpful push from the OPEC nations and public

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concern in general over foreign ownership of U.S. property and industry--these concerns were focused in Congress and resulted in the passage of the IBA. As I have indicated earlier, the IBA has brought what I would consider sweeping changes in the structure of foreign banking in the U.S. and I predict that those changes will continue at an accelerating rate.

(i) Current options

First, the number of forms in which foreign banks operating here may be conducted has been greatly increased. In addition to federally or state chartered subsidiary banks and state chartered branches and agencies (the principal forms of pre-IBA entry) a foreign bank may now operate in the form of an Edge Act corporation and may have domestic and foreign branches of such a corporation. Including commercial lending companies (the IBA's term for Article 12 New York investment companies) the forms of operation available to foreign banks now number at least ten.

Equally important under the IBA, foreign banks now have the opportunity of selecting either a federal or a state charter for branches and agencies and have the option of chartering a branch with either limited or unlimited deposit-taking ability, further increasing their flexibility.

Let me illustrate this point with three hypotheticals. Let us take a foreign bank that wishes to establish its initial branch office with unlimited deposit-taking powers, and that wishes such branch to be federally chartered. A foreign bank may select any state in the union in which to locate such a branch, so long as the Comptroller of the Currency approves the establishment of the foreign bank branch and it is not prohibited by state law. Cam MacRae is going to discuss certain provisions of the Comptroller's regulation that are now being challenged in the courts [3].

Assume that our hypothetical foreign bank already has a retail deposit-taking branch in one state and wishes to establish another branch in another state. The foreign bank may do so if the deposit-taking powers of the second branch are limited to those allowed to an Edge Act corporation and--if the branch is to be federally chartered--its operation is expressly permitted by the law of the state in which it is to be located. With the exception of this restriction on deposit-taking powers, such a branch would have all of the banking powers, including fiduciary powers if it asked for them, of an existing national bank, not foreign owned.

Finally, assume a hypothetical bank wishes to establish a federally chartered entity of some kind outside its home state that can accept deposits from persons who are not citizens or residents of the U.S. Such a bank could seek to establish a federally chartered agency. The Comptroller's regulations allow such deposits. On the other hand, a state chartered agency of a foreign bank cannot accept such deposits. It can only maintain credit balances. In my view the Comptroller's regulation permiting a federally chartered agency to accept such deposits conflicts with a section of the IBA which prohibits receipt of such deposits.

(ii) Federal controls

As I have already suggested, the IBA establishes a substantial level of federal control in the areas of foreign bank entry, market expansion, and regulation. Except for the initial state branch in the home state, all forms of state and federally chartered foreign bank entities are now obligated to satisfy one or more requirements of the IBA before they commence operations. There is no time to go

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into all of those now, but Neal Petersen is going to touch on some of them later [4]. For example, a federal branch or agency of a foreign bank must not be prohibited by state law and it must be approved by the Comptroller.

In addition, in acting on an application to establish a federal branch or agency, the Comptroller must consider the financial and managerial resources and future prospects of the applicant and, in language giving the Comptroller rather broad discretion, the IBA requires the Comptroller to consider the effect of the proposal on expansion of competition in the U.S. and in foreign commerce. That is a rather strange provision and we will discuss the antitrust issues a bit later [5].

(iii) Types of offices

I will conclude this part of my remarks by summarizing the different types of offices maintained in the U.S. by foreign banks:

(1) *REPRESENTATIVE OFFICES - 249*

These offices must file a report with the Treasury Department and, as far as I know, nothing much more happens with those reports once filed. 192 banks from 48 foreign countries were represented by these offices in 1980.

(2) *COMMERCIAL LENDING COMPANIES - 6*

These fit the description of the so-called Article 12 New York investment companies.

(3) *STATE CHARTERED AGENCIES - 171*

(4) *FEDERALLY CHARTERED AGENCIES - 5*

Applications for three additional agencies are pending.

(5) *EDGE ACT CORPORATIONS - 16*

There are 121 foreign and domestically controlled Edge Act corporations with 66 branches. Foreign banking organizations have invested in only 16 of these, and one of the 16 presently has a branch.

(6) *STATE CHARTERED BRANCH WITH LIMITED DEPOSIT-TAKING POWERS*
(7) *FEDERALLY CHARTERED BRANCH WITH LIMITED DEPOSIT-TAKING POWERS*
(8) *STATE CHARTERED BRANCH WITH FULL DEPOSIT-TAKING POWERS*
} *142*

(9) *FEDERALLY CHARTERED BRANCH WITH FULL DEPOSIT-TAKING POWERS - 12*

(10) *SUBSIDIARIES - 42*

A number of these represent acquisitions of existing U.S. banks.

This summary indicates that foreign banks have not yet taken significant advantage of the federal option in branching, nor have they taken advantage of the ability to branch Edge Act companies that they now, or may in the future, own.

Before closing, I want to remind you of the substantial amount of literature which has been growing in this area. A bibliography is appended at the end of the chapter. I particularly recommend the Fed's 1980 study of the first years of operating under the IBA.

(iv) Edge Act branches

I will end my comments at this point with an option that is available to an international bank and is, I think, the wave of the future: that is, the Edge Act route for foreign bank expansion. The IBA amended the Edge Act by eliminating the requirement that the directors of Edge Act corporations must be citizens of the U.S. It also provides that the foreign bank may, with prior Fed approval, own a majority of the shares of such corporation. I do not want to sound like a law professor here, but an Edge Act corporation is a rare and wondrous thing. There are three kinds of powers it has.

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One would be what I have described as general banking powers. Those are enumerated in the Edge Act, and they run a page and a half or so. Edge Act corporations can purchase and sell securities, accept bills and drafts, issue letters of credit, and engage in a wide variety of finance transactions. The second kind of power they have--and again this creates a significant advantage over domestic banks--is the power to purchase stock in other corporations, something which is very restricted for domestic banks. Last--and this is a new power that all Edge Act corporations were given by the IBA--they can branch anywhere that the Fed allows. Prior to the IBA, a domestically-owned Edge Act corporation could not branch. By amending the Edge Act to provide for foreign bank ownership, the IBA extended this new entry option by allowing for branches. Although I predict that there will be significant litigation, I believe it will come to pass that the Edge Act entry option will be the most expeditious way to penetrate U.S. banking markets.

(v) Obstacles to Edge Act branching

MR. MUNDHEIM: Neal Petersen, has the Fed interposed any obstacles to the Edge Act branching of foreign banks?

MR. PETERSEN: We have not interposed any objections in that area. I do not think we have seen any instances yet of foreign Edge Act branching. Most of the branching has involved the conversion of existing domestic Edge Act subsidiaries into a branch structure. Large banks had established a number of Edge Act subsidiaries around the country as separate corporations; and with the change in the Federal Reserve regulations, many of those subsidiaries were converted to branches. There is nothing in the IBA that deals directly with branching; however, we felt that the general purposes of the Edge Act provisions and the IBA amendments to the Edge Act gave us the authority, which we had not previously decided we had, to permit branching.

As a result, there have been these conversions and mergers of existing multicorporate Edge Act operations into branch structures. These have been very routinely approved by the Board. I would expect that expansive branching by existing Edge Act corporations--including foreign owned Edge Act corporations--would not receive any particular objections from the Federal Reserve. I would caution you, though, that as this trend continues, and if it develops to the degree that Dennis Lehr suggests, there may well be some challenge to our interpretation that branching is permitted under the Edge Act as it was amended by the IBA. I think that issue still lingers. It will be a particularly troublesome issue if the Board ever adopts a version of the so-called qualified business entity concept.

In regard to qualified business entities, you may recall that the staff suggested that the Board propose a new creature by that name, for which an Edge Act corporation could provide a full range of banking services including full lending and deposit-taking powers. The test proposed at the time--about a year or so ago--was that the qualified business entity, on an unconsolidated basis, must base two-thirds of its business on sales or purchases from international business. There were various other tests proposed that would measure the qualifying "international business". This particular proposal was not acted upon by the Board when it adopted the branching regulations, because of the political fire storm in opposition that appeared to be developing among various state regulators and regional banks.

This concept has not gone away. The staff may well come back

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to the Board in the near future with another attempt at redefining the idea of qualified business entity--maybe in a somewhat different fashion. If the Board adopts the concept, its implementation will considerably expand the ability of Edge Act corporations to do a full range of banking services, although to a rather discrete type of customer. Nevertheless, this might be perceived as a significant breach of the spirit of the McFadden Act--not necessarily the letter of the McFadden Act--and I would expect we would find much political and judicial effort to prevent it.

2. RESTRICTIONS ON FOREIGN BANKS

MR. MAC RAE: Now that Dennis Lehr has focussed on the attractive options that are available to foreign banks, I am going to perform the typical lawyer's job of giving you the bad news and focus on some of the more important restrictions that are applicable to foreign banks. In so doing, I am going to try to give you a picture of the complex "banking landscape" that we now have in the U.S. as a result of the IBA.

A. Restrictions on Entry

First, let us examine the interstate banking restrictions. Dennis has told you briefly about the McFadden Act [6], which limits branching across state lines, and the so-called Douglas amendment [7], which limits interstate acquisitions by holding companies.

In essence, the IBA made these same general restrictions applicable to foreign banks--but it did so with a few "twists" and compromises. As a result, subject to a few important exceptions, a foreign bank is now prohibited from maintaining a branch outside something called its "home state". (I will tell you a little more about home state later.) Similarly, a foreign bank is now generally prohibited from acquiring another bank outside its home state [8]. But as I noted, there were some important exceptions that were made available to foreign banks.

(i) Exceptions to the general rule

The first major exception for foreign banks was the so-called grandfathering rule, which allowed a foreign bank to continue to operate any branch or banking subsidiary that had commenced operation (or had been applied for) on or before July 27, 1978, even though the office was outside its home state. This meant that a bank that had moved fast could have kept offices in, say, four or five states, if they had at least been applied for prior to the grandfathering date.

A second group of exceptions made it clear that the foreign bank could still establish other offices outside its home state, provided they eschewed the taking of domestic deposits. Thus, a plethora of interstate agencies or so-called limited branches could theoretically be permitted. (And note that the IBA actually expanded upon the practical availability of such options, because it opened the way for obtaining a federal license for agencies and limited branches.)

(ii) Home state rules

Obviously, the determination of a foreign bank's home state is a crucial linch-pin to the operation of the interstate banking restrictions. How then does a foreign bank go about selecting its home state? Does it just hang out a sign saying this is "home sweet

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home"? Well, it is pretty close to that.

The Federal Reserve Board issued its definitive regulations in October of 1980, instructing banks how to go about selecting their home state [9]. Incidentally, the foreign banks that now have multistate operations had until March 31, 1981, to select their home state, and there were some fascinating deliberations going on among certain institutions as to which state to select. Let me just quickly give you some highlights of the home state selection regulation.

First, as I said, a bank can select its own home state; but if a bank does not select it, then the Federal Reserve will graciously select it for the bank. The regulation also permits a bank to change its home state once, but only once. This restriction was not specifically contained in the IBA, but it was probably necessary to prevent possible abuses of the home state concept. Obviously, if a bank has just one branch in one state, then that has got to be its home state. But the real fascination occurs in the case of a bank that had offices as of July 27, 1978, in a number of states. Such a bank may have some very tough decisions in choosing its home state.

Let me take an example. Let us say a bank had a branch in New York and an agency in another state, such as California [10]. Under the home state rules, if the bank were to designate the state in which its agency was located as its home state, then suddenly it would be able to expand the powers of that agency into a full deposit-taking branch and still keep its original grandfathered branch in New York. So you could get two branches for the price of one.

Now, it would get a bit more complicated if the bank later wished to change its selection. Let us say, after selecting California as the home state, a year later the bank wanted to acquire another bank located in New York. In such event, the bank would be permitted to switch its home state to New York; but it would have to give up its domestic deposit-taking powers in California, thereby reverting to an agency status in that state.

(iii) Three sets of rules

I am not going to spend any more time on these rules because they can get very complicated, particularly in the acquisition area. But I did want to tell you about them to illustrate that there are now really three sets of principles applicable to banks in the U.S. in the interstate area. First, there are the rules that apply to domestic U.S. banks. Second, there are the rules that are applicable to foreign banks that do not have any grandfathered branches (but are still allowed out-of-state agencies and limited branches). And third, there are the rules applicable to those lucky foreign banks that have grandfathered facilities [11]. Thus, it is true that the "playing field", if you will, has become a good deal more level, but there are still some interesting variations in the terrain.

B. Non-banking Activities

I now want to move from the pure banking area, and turn to the question of non-banking entry in the U.S. This is actually a very important area for foreign banks, because foreign banks quite typically have a lot broader powers and non-banking operations than American banks. They quite often engage in underwriting and distribution of securities, and indeed they often have manufacturing and industrial affiliates. In theory, the IBA attempted to apply to foreign banks the same types of general restrictions against non-banking entry that were previously applicable to domestic banks under

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

the Bank Holding Company Act [12]. Just as in the interstate banking area, they did so with some compromises.

(i) Securities

Let us take underwriting and dealing in securities. At present, the well-known Glass-Steagall Act [13] severely limits domestic banks' activities in that area. But if a foreign bank had an underwriting and securities affiliate established and operating on or prior to July 26, 1978, then it would be entitled to keep that affiliate. On the opposite side of the coin, if a foreign bank today had any ideas about setting up or acquiring a securities affiliate, I am sure Neal Petersen would quickly tell them that that is now flatly prohibited by the IBA. In short, with the exception of grandfathered securities operations, foreign banks are now covered by essentially the same restrictions on securities activities as domestic banks.

(ii) Manufacturing

The situation gets a bit more complex when one examines the status of manufacturing or industrial subsidiaries or affiliates of foreign banks. Let us take the case of a shoe manufacturing company. I am sure everyone in the audience is saying, "If you cannot have an underwriting affiliate in the U.S., certainly no foreign bank could ever have a shoe manufacturing affiliate here." Well, that is not true. The foreign bank may well be able to do just that. Under the provisions of Regulation K [14] of the Federal Reserve Board--which were quite recently promulgated and which interpret related provisions of the IBA--there are ways in which a foreign bank could be permitted to have a shoe manufacturing or other clearly non-banking subsidiary in the U.S. Briefly, assuming the foreign bank (and any parent holding company) qualifies for the exemptions provided in Regulation K, then either it (or any parent company) could have a foreign subsidiary which directly or indirectly engages in a non-banking activity here, *provided that* (1) more than fifty percent of the foreign subsidiary's consolidated assets and revenues are located in or derived from outside the U.S. *and* (2) the proposed activities in the U.S. are the same kind of activities as the foreign subsidiary conducts abroad. Thus, to return to our hypothetical example, a qualifying foreign bank would be permitted to let one of its foreign subsidiaries or affiliates in the shoe manufacturing business open up or acquire a slightly smaller shoe manufacturing operation in the U.S. [15].

(iii) Compromises

What I am trying to illustrate here is that the rules we now have were based on some compromises that the draftsmen of the Act and the regulators have had to make, to take into account some existing facts that they really could not do much about. For example, one of those facts was that at the time of the passage of the IBA a number of foreign banks already had in place in the U.S. facilities that would not have been permitted to domestic banks under the Glass-Steagall Act. Another fact of life was the significant non-banking affiliations of a number of foreign banks.

I actually think the compromises that have been developed were fairly enlightened, given the existing landscape the legislators and regulators had to work with. But, just as in the interstate banking area, one is left asking some basic questions about the underlying restrictions that exist in our banking system. Put another way, the interstate and non-banking activities restrictions contained in the IBA have considerably leveled the playing field on which foreign and domestic banks now compete; but at the same time, the field is not

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entirely level. One is thus left with the nagging question whether the American system of restrictions, or playing field if you will, is outdated in today's world of universal banks.

C. Dual Banking System Problems

Now I will not succeed in my goal of thoroughly confusing you if I do not touch on one other complication for entry of foreign banks in the U.S., which is caused by the fact that there is a dual banking system in the U.S. Prior to 1978, foreign banks could open a branch or agency only pursuant to a state license [16]; thus, they were mainly exposed to only one side of our dual banking system. However, since the enactment of the IBA, foreign banks now have the option to seek either a federal or state license for a branch or agency. This has exacerbated certain tensions that already existed in the dual banking system.

Some of these tensions have been healthy. Thus, there has been a certain amount of competition between the Comptroller of the Currency and certain state regulatory agencies to provide more options and powers for the banks that are licensed by them, in an effort to make their respective licenses more attractive.

For example, to compete against the fact that some perceive federal branches and agencies as being more attractive, the New York State Banking Department has spearheaded a legislative and regulatory revision to permit New York State licensed agencies to issue "large denomination obligations" that in essence are certificates of deposit [17].

At other times this competition between regulatory agencies might not prove to be so healthy, as there has been a bit of competition to eliminate certain protective requirements that were previously applicable to the foreign banks. For example, the Comptroller did not impose a so-called maintenance of assets requirement upon federally licensed branches and agencies, which for a while stood in contrast to New York's former requirement that foreign branches maintain a margin of 108 percent assets to liabilities. In response, the New York Superintendent of Banks sought legislation, and implemented regulations, to permit a relaxation of New York's requirement [18].

Finally, the competition within the system of dual banking regulation of foreign banks has even resulted in some genteel mudslinging between the federal and state regulatory agencies. The New York Superintendent of Banks and the Conference of State Banking Supervisors had noted with some alarm that the Comptroller of the Currency was permitting federal branches and agencies to do a few things that state branches and agencies could not do.

For example, federal agencies were permitted under the Comptroller's regulations to take deposits from non-U.S. citizens [19]; in contrast, neither domestic nor foreign deposits are permitted at most state agencies. Similarly, certain foreign banks that were previously foreclosed from obtaining a state license, because their home country lacked so-called banking reciprocity [20], were permitted to obtain a federal branch, under the Comptroller's interpretation of his authority under the IBA.

As a result of this dichotomy, the Conference of State Bank Supervisors and the Attorney General of New York brought a lawsuit against the Comptroller challenging certain of the regulations that the Comptroller had issued [21]. It is hard to predict how the action will turn out. But the ultimate decision will turn on the in-

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terpretation of a very few possibly ambiguous phrases in the IBA. Thus, for example, the issue of the reciprocity requirement will primarily turn on whether the language that authorizes the Comptroller to license a branch in any state where the establishment of a branch "is not prohibited by State law" [22] bars a federal branch only in a state where there exists a *flat* prohibition against branching, as opposed to a statement of state criteria for an acceptable foreign bank branch.

3. DIRECT ACQUISITION OF EXISTING BANKS

At this point we are running short on time, and I wish to leave some time for Dennis Lehr to address perhaps the most controversial area of foreign bank entry--that is, direct acquisition of existing U.S. banks. I would only note, by way of introduction to this subject, that this is the area where the advantages of foreign banks are perceived (and I believe rightly so) to be the most significant at the present time.

MR. LEHR: I am going to skip most of the statistics on foreign bank ownership. These are readily available in the Comptroller of the Currency's studies listed in the bibliography. But for those who cannot resist some statistics, let me just point out that of the three hundred largest U.S. banks, only twenty-six are foreign owned, and that includes foreign banking organizations or individuals. Unfortunately, the meaning of "ownership" is not agreed on in the different government reports. One government study uses a ten percent ownership test and thus, if a foreigner owns ten percent of the stock, that study includes a hundred percent of the bank's assets as "foreign owned".

A. Antitrust Law in Banking

I have been asked to say something about antitrust law. This area of the law presents many issues that lawyers get excited about. In the banking context, antitrust prohibitions generally prevent one banking organization from acquiring another, because after the acquisition the combined entity will be too big--that is, it will reduce competition in the market. Just where is, and what is, the relevant market in any proposed combination leads to a lot of legal business.

In talking about competition in a market, we often find ourselves in a kind of numbers game. We talk about dominated markets, and controlled markets, and elimination of actual and potential competitors. There are certain assumptions built into our antitrust law which generally favor more, rather than fewer, competitive units. Ultimately, these laws are supposedly applied for the benefit of the consumers of the services of whatever business is expanding. In our case, that would be just the everyday bank customers.

(i) Anti-competitive effects

In the context of foreign bank expansion in this country, I believe our antitrust laws can be viewed from two perspectives. I have considered what the federal regulators have done with respect to the antitrust criteria that they are supposed to apply; and I have tried to ascertain what standards they may apply in the future. First, I will briefly summarize what the federal agency decisions have shown in the last few years.

Recent decisions have revealed that anti-competitive effects were of significant concern to the federal agencies in only a very

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small number of acquisition cases. As an example, we shall look at the Fed's opinion approving the acquisition of Union Bank in California by Standard Chartered of London. The opinion, I think, is worthy of examination for the manner in which it seems to downplay the anti-competitive effects of the transaction and its emphasis on the pro-competitive effects. I am personally in sympathy with this approach.

At the time Standard Chartered sought to acquire Union, Union was the sixth largest banking organization in California. California has some very large banks, including Bank of America. Standard Chartered of London had a subsidiary located in San Francisco, and that subsidiary was the twenty-first largest bank in the state. The impact of the transaction on actual competition, according to the Fed, was limited to only three markets. One of the primary reasons that the Fed concluded that the effect of the transaction on existing competition in those markets was only "slightly adverse" was because Union Bank was a relatively small competitor compared to the largest banks in those markets. I fully agree.

However, those who oppose this view would say that in one of the three markets--in particular, the most significant market in the state (the Los Angeles metropolitan area)--Union Bank was the fourth largest bank. As the fourth largest bank in that market, it, together with the three other largest banks, controlled seventy-one percent of all deposits; that is, the four banks out of one hundred and five in that market had seventy-one percent of the deposits. Had this been a domestic acquisition within the state, the Fed's decision, I believe, would have come out the other way. The Fed did not believe there was any direct impact on potential competition. Rather, it placed great significance on the pro-competitive aspects of the acquisition, with particular emphasis on the representation by Standard Chartered that it would provide Union with twenty-five million dollars in new capital.

Here, again, was a situation that banking lawyers find quite anomalous. Union was a bank in a weak capital condition. Yet because of our domestic antitrust laws, no eligible U.S. bank large enough to supply the needed capital could acquire it; thus, Union had to look out of state for help. I hope Bob Carswell later will comment on the prospects for some loosening of those restrictions [23].

(ii) Future trends

In short, my review of foreign acquisition decisions shows that the federal regulators have not, to date, been significantly troubled by the anti-competitive effects of foreign acquisitions. But what of the future? Pressures have now been exerted on the federal agencies by some members of Congress to consider the worldwide effect as well as domestic competitive effects of U.S. bank acquisitions by foreign banking organizations.

This is significant because the authority under which the domestic banking agencies approve these acquisitions clearly says that they should look only to *domestic* markets. The Bank Holding Company Act and the Bank Merger Act, both direct the federal agencies to consider competitive effects in any section of the "country", meaning the U.S.; and it has been the practice of the agencies to limit their review accordingly. Perhaps the economists at the Board and elsewhere, for one reason or another, sometimes gratuitously mention the effects on commerce outside the U.S. Correct me if I am wrong, Neal, but I think in the acquisitions of Marine Midland and National Bank of North America, the Fed made reference to the effects of the

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acquisition on international markets. To date, however, no federal agency has denied a bank acquisition based on international market considerations. As I indicated, my own view is that our federal regulators should continue to look at our own domestic markets, to which the statutes under which they operate direct them.

I find support for this view in a recent decision--handed down on February 20, 1981, by the U.S. Court of Appeals for the Second Circuit [24]--involving National Bank of Canada's loss of its Master Charge business, allegedly through a Sherman Act violation by an American financial institution. The violation of our antitrust laws, it was alleged, occurred outside of the U.S. In the last sentence of the opinion, the court said that "anti-competitive effect upon U.S. commerce" must either occur within the U.S. or affect export commerce from the U.S. Thus, I think it is irrelevant, and I hope it will remain so, whether Standard Chartered or any other foreign bank should choose to monopolize the markets in Indonesia, in Sri Lanka, or anywhere else. Our regulators should just confine themselves to the U.S. markets.

B. Acquisition Techniques

MR. MUNDHEIM: Laying aside antitrust problems, suppose a foreign bank has a branch in New York and it would like to acquire a bank in Atlanta. It has operated that New York branch since 1970. Any problem with that?

MR. LEHR: No, because that branch is grandfathered. When I say no, I am not current on Georgia law, but I am assuming Georgia law does not prohibit foreign bank ownership. The foreign bank could then acquire a bank in Georgia.

MR. MUNDHEIM: And make that its home state?

MR. LEHR: That is correct.

MR. MUNDHEIM: Now suppose that in addition to that New York branch, a subsidiary of the foreign bank also had securities activities in the U.S. The foreign bank now acquires the Georgia bank. You have said that it can continue to operate the New York branch and the new Georgia bank that it acquired. Must it dispose of its securities business?

MR. LEHR: My understanding is that those securities affiliates were also grandfathered if they were operating as of July 1978.

MR. PETERSEN: That is a correct interpretation only if the Georgia operation is a branch or agency.

MR. MUNDHEIM: If the Georgia bank becomes a subsidiary of the foreign bank, would there be Bank Holding Company Act problems? Could you rely on the IBA grandfathering provisions to help solve the Holding Company Act difficulty?

MR. LEHR: Bob, a banking lawyer would advise you to do the transaction as a purchase of assets and assumption of liabilities, and to go in as a full deposit-taking branch. Then you could keep all three operations going and you would not have the Bank Holding Company Act problem. You would get the benefit of the grandfathered branch and the securities company in New York.

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C. Controlling Foreign Acquisitions

MR. PETERSEN: I have a comment regarding a couple of things that Dennis Lehr and Cameron MacRae mentioned with respect to entry alternatives. Dennis was very bullish on the Edge Act as a technique for foreign bank entry. I think I would agree with him in terms of the future prospects for Edge Act activities.

(i) Edge Act corporations

There is an additional advantage for Edge Act corporations which so far the Board has not taken away. Entry by way of an Edge Act subsidiary would not make the foreign banking organization subject to the various non-banking prohibitions of the Bank Holding Company Act, as would be the case if the foreign bank came in by way of a branch or a direct subsidiary. When the Board originally proposed its Edge Act revisions in 1979, it would have required conformity to the non-bank restrictions of the Bank Holding Company Act for any Edge Act subsidiary. Questions were raised about whether the Fed had authority to do that, and ultimately the Fed backed off. We still think we have the authority to review any such activities if they are inconsistent with the purposes of the Federal Reserve Act and the Bank Holding Company Act. But at the moment, there is a theoretical advantage (perhaps a real one if you do not push it too far) with respect to non-bank activities if you come in by way of an Edge Act corporation.

(ii) Non-banking activities

Another word about non-bank activities. In some instances a foreign bank holding company can have an ice cream manufacturing or shoe manufacturing company subsidiary but cannot have a subsidiary in a closely related financial field. That is anomalous. There is a provision in section 8 of the IBA which provides that if the foreign bank wants to engage in an activity that is of a financial nature or closely related to banking under Section 4(c)(8) of the Bank Holding Company Act (governing permissible non-banking activities for bank holding companies), the foreign bank holding company must make an application to the Federal Reserve. In that case, the holding company does not get the benefit of the automatic ice cream parlor exception.

The Board took the position that the statute meant that an application is required not only if the activity is already on the so-called laundry list (such as mortgage banking), but also if it is generally within Division H of the standard Industrial Classification Code (covering, generally, financial activities). The purpose was to avoid permitting foreign banks to gain a competitive advantage in providing financial services in the U.S.

The clearest example is an insurance activity that is not on the 4(c)(8) laundry list, but which, if conducted by a foreign bank, might give it a considerable advantage in competing with U.S. banks. On the other hand, if the foreign bank had an ice cream parlor, it would not, presumably, have any great competitive advantage over U.S. banks. This is an example of the push-pull between the need to understand domestic concerns and the desire not to discourage foreign bank entry into the U.S.

D. Objections to Foreign Acquisitions

MR. MUNDHEIM: When the Hong Kong and Shanghai Bank sought to acquire Marine Midland, a good deal of unfavorable publicity was generated, and one question raised was whether as a matter of policy it

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is undesirable to permit foreign acquisition of substantial U.S. banks. The recent speculation about the acquisition of a major bank on Long Island by a foreign bank has re-ignited that question. Fred Heldring, what do you think about allowing foreign banks to make acquisitions of substantial U.S. banks?

MR. HELDRING: Well, there are in my mind two issues. I go on the assumption that no country likes--to put it in an extreme--to have one hundred percent of its banking system owned by foreigners, and that would include the U.S. So the question arises, what is enough? Perhaps we have reached that point. A little clarity on that subject would be helpful.

The second point I would like to make--which has not been discussed as much--concerns the impact upon individual communities of acquisitions in the private sector generally and in banking in particular. The life of a community is dependent to a large extent upon a healthy, and sound, and independent private sector. In that kind of private sector an independent banking system plays quite an important role. To the extent that communities become branch towns or subsidiary towns, this health and soundness of the community is endangered, and we see the results of this in some cases.

I think these two questions arise when you think of the Long Island case. It is not just because a foreign bank is involved; the same situation would exist if any other bank acquired that particular bank on Long Island. There may not be much left on Long Island in terms of independent banking, and that raises a question as to what it does to a community.

MR. MUNDHEIM: Perhaps our German colleague, Professor Fritz Kübler, has a comment on that point of view.

MR. KÜBLER: I feel that this point is particularly interesting; and I am sure that my countrymen would be unhappy if even less than one hundred percent of the German banks were taken over by American banks. It might cause some uneasiness if, for instance, the Deutche Bank were taken over.

Concerning local communities, it occurs to me that the question is one of structure. We have been safe, but largely because the local banks tend to be cooperatives or savings banks, which are organized under public law. It might be possible to take over a savings bank, but it is technically and legally so complicated that it just has not been done so far. The question that arises for me is whether this is primarily a structural problem, so that you need do no more than keep banks reasonably small in the local community. Or, are banks somewhat different from normal businesses so that, because they are performing a public service, they should be under some form of special regulation as far as foreign acquisitions are concerned? I would like to give that question back to the panel.

MR. VAGLIANO: I think the question is basically one of the validity or non-validity of local control. Therefore the problem is not really foreign versus American: it is actually not a foreign bank problem. It is a question of the structure of the banking system here, and whether the local communities benefit more or less from local control. Of course, that is a terribly long argument.

I think there can be a political reaction in this country if it is perceived more and more that foreign banks have special advantages. The IBA has, in a sense, attempted to bring greater clarity and greater uniformity. Still, there are real advantages in terms

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of functions (either because of grandfathering, or because of the law and the interpretations that may follow from the law, or because of antitrust regulation) and because of the fact that reciprocity is not really part of this whole concept. So I can foresee, and this might particularly happen if a very large bank were acquired by foreign interests, that this entire subject could be reopened politically.

MR. MUNDHEIM: Neal, you had a comment?

MR. PETERSEN: Yes. In a number of Board orders approving major foreign acquisitions, there have been rhetorical--I guess I would put it--statements raising concerns about the market share of foreign organizations in a particular market. However, those statements have not necessarily been a factor in any decision one way or the other. Under the present Bank Holding Company Act there are real questions as to whether the degree of foreign market share per se necessarily gives the Board any basis for denial.

There is an argument, I suppose, that the so-called convenience and needs tests under section 3 of the Bank Holding Company Act could be stretched a bit to cover the problem, particularly if a record could be developed to show that, indeed, the local market would not be adequately served because of excessive foreign ownership. On that point, however, the studies done to date (for example, the General Accounting Office report and our own report on foreign banking in the U.S.) have indicated that there has been no real walking away from local markets after foreign banks have come in. Indeed, the evidence seems to suggest the contrary. Having said all that, I would certainly agree with the comment that this is a political hot potato.

There have already been a number of hearings in the Congress of the U.S. on this subject, and there have been proposals floated that would change the test for acquisition of banks by bank holding companies, both foreign and domestic holding companies. Anything that might be adopted to change tests under the Bank Holding Company Act, which would go beyond the present antitrust concerns and the existing convenience and needs test, may well end up being applied across the board to both foreign and domestic companies.

One proposal was to apply what we call a public benefits test to either foreign bank acquisitions or--more likely--any bank acquisition over a certain size. The test would be very similar in concept to the so-called benefits test under section 4(c)(8) of the Bank Holding Company Act, having to do with non-banking activities. The test basically says, if there are any adverse effects as defined in the statute (such as undue concentration of resources, unfair competition, etc.) they would have to be outweighed by some public benefit. On the other hand, if there are no adverse effects, we interpret section 4(c)(8) to say you do not have to have a positive public benefit. That test might be modified to require demonstration of a *positive* public benefit.

There have also been some who propose an automatic cut-off if a market share gets over a particular size in the hands of foreign banking organizations. That would be very difficult to apply administratively and could cause some very serious problems with our friends overseas in terms of possible retaliation. This concept is similar to Senator Proxmire's Competition In Banking Act (which he introduces in every Congress) which would put a limit on an acquirer

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if it would control more than a certain percentage of the deposits in a particular state.

I think that this subject will continue to be before the Congress notwithstanding a change in the leadership of the Congress or a change in the Administration. Senator Heinz--who is a Republican--is very, very concerned in this area. Representative Rosenthal and Representative St. Germain on the House side--who are Democrats --are also very concerned. So, I do not think it is a partisan political issue; but it is a very, very important issue for many members of Congress, in terms of the particular banking structure in their district and, indeed, in the country. I would say the Board has no pending proposals under consideration to make any of these changes. I am just mentioning that these are the kinds of ideas that have been suggested both by members of Congress and, informally, by some regulators.

MR. MUNDHEIM: Fred, one minute for a final comment on this issue.

MR. HELDRING: Right. I certainly do not want to pursue it any further, but I want to clarify the point I made on the soundness of the community. Admittedly, what I am saying applies to all acquisitions and not only to acquisitions by foreigners. When you have an independent local company, it will make contributions, both in talent and in money, to vital non-profit activities in the community. As soon as that company is taken over, both organizational and financial aid ceases. At the present time there are many communities where it is mainly the bankers and lawyers who are still involved in these kinds of effort. Now, if the bankers get acquired and lose their independence, that may be rather serious for some of these communities.

MR. LEHR: I want to note my deep disagreement with Fred Heldring.

MR. MUNDHEIM: I think we should recognize that there are two sides to this debate and we could argue the merits at length. But we must turn to our next topic.

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NOTES

[1] International Banking Act of 1978, 12 U.S.C. §§3101-3108 (Supp. III 1979).

[2] 12 U.S.C. §§611-632 (1976).

[3] Chapter I §2C *infra* at 12.

[4] Chapter II *infra* at 27.

[5] Chapter I §3A *infra* at 13.

[6] The McFadden Act, as amended 1962, 12 U.S.C. §36(c) (1976), provides that a national bank may only establish branches "at any point within the State in which said association is situated...." As to state banks, it should further be noted that no state has yet adopted legislation that would permit out-of-state banks to establish branches therein.

[7] 12 U.S.C. §1842(d) (1976).

[8] *See generally* §5(a) of the International Banking Act of 1978, 12 U.S.C. §3103 (Supp. III 1979).

[9] Regulation K of the Federal Reserve Board, 45 Fed. Reg. 67,058 (1980) (to be codified in 12 C.F.R. §§ 211.21, .22).

[10] It should be noted that the Federal Reserve Board concluded that the form of "branch" which foreign banks had previously been permitted to open in California was to be deemed to be an agency for purposes of the interstate banking regulations, because in the past such a California "branch" was effectively restricted from taking domestic deposits.

[11] Of course, there are also certain domestic bank holding companies that have grandfathered subsidiaries in more than one state.

[12] 12 U.S.C. §§1841-1850 (1976 & Supp. III 1979).

[13] The Banking Act of 1933, 12 U.S.C. §§24(7), 78, 377, 378 (1976 & Supp. III 1979).

[14] Regulation K, 45 Fed. Reg. 81,540 (1980) (to be codified in 12 C.F.R. §211.23) promulgated January 3, 1981.

[15] Interestingly, clearly non-banking activities that would be permitted under Regulation K would not require the approval of the Federal Reserve Board. However, activities to be engaged in by a subsidiary that "consist of banking or financial operations, or types of activities permitted by regulation or order under Section 4(c)(8)" of the Bank Holding Company Act will only be permitted upon the *prior* approval of the Federal Reserve Board.

[16] Of course, a foreign bank could have acquired either a state or federally chartered subsidiary bank.

[17] New York Banking Law §202-a (McKinney 1971); General Regulations of the Banking Board, 3 NYCRR Part 81.

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[18] *See* 12 C.F.R. §28.9 (1981); and New York Banking Law §202-b(2) (McKinney Supp. 1980); and General Regulations of the Banking Board, 3 NYCRR Part 52.

[19] *See* the definition of "agency" contained in 12 C.F.R. §28.2(b) (1981).

[20] An example of a state reciprocity requirement can be found in §202-a of the New York Banking Law, which stipulates that a foreign banking corporation may be granted a branch license in New York *provided* a bank or trust company located in New York may maintain a branch, agency or wholly-owned subsidiary bank in the foreign bank applicant's country.

[21] Conference of State Bank Supervisors and Robert Abrams v. John G. Heimann, No. 80-3284 (D.D.C. 1981).

[22] Section 4(a) of the International Banking Act, 12 U.S.C. §3102 (Supp. III 1979).

[23] Chapter V §2C(v) *infra* at 71.

[24] Nat'l Bank of Can. v. Interbank Card Ass'n and Bank of Montreal [1980-81] Trade Cas. (CCH) ¶63,836 (2d Cir. Feb. 20, 1981).

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APPENDIX I

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A SELECTED BIBLIOGRAPHY*
(as of January 30, 1981)

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https://scholarship.law.upenn.edu/jil/vol3/iss3/1

Journal of Comparative Corporate Law and Securities Regulation 3 (1981) 225-237
North-Holland Publishing Company

Supervising Multinational Banking Organizations:

RESPONSIBILITIES OF THE HOST COUNTRY

Neal L. Petersen

MR. MUNDHEIM: Assume that we have a foreign bank with a branch or a subsidiary in the U.S. What are the supervisory responsibilities of the host country? Neal, will you start us on the answer to that question?

MR. PETERSEN: Thank you, Bob. We are now assuming Colossus International is in the U.S., either through a subsidiary or through a branch or agency. I want to discuss some of the supervisory practices that the U.S. applies to these institutions, and I shall use as a working example the history of the famous Y-7 and related forms. For those of you in the banking business those are probably code words that you know all about, but I will explain it in a little more detail for the others.

1. PRINCIPLES OF SUPERVISION

I shall start with a basic principle that cuts across the board, whether you are talking about a domestic bank operation or a foreign bank operation in the U.S. There is a fundamental principle in our system which holds that a parent of any banking organization is looked upon as a source of strength for its subsidiary banking operations. We apply that concept consistently in the domestic bank holding company field, and we will apply it in the international field with respect to foreign banks having branches or subsidiaries in the U.S.

This point of view may be somewhat different in emphasis from the perceptions of my colleagues who would argue very strongly that you have to look at banking on a consolidated basis worldwide, and that it is really the home country that has the primary and last-resort responsibility. I would not necessarily disagree with them, but we have put a little gloss on that concept. As the host country, we are indeed concerned with and do look to the foreign parent as a source of strength. And we have said that--the Board said that in February 1979 in a publicly issued policy statement [1]. The Federal Financial Institutions Examination Council (another bank regulatory agency, made up of all the other bank regulatory agencies to coordinate supervisory policies and forms) issued a very similar statement later in 1979, in July or so [2].

Overlaying the application of this principle are the peculiarities of our own domestic banking system, in terms of what we think our domestic banking system should look like and, therefore, what foreign banks should try to do when they are here. These concerns, again, have been touched on by Dennis Lehr. We have a dual banking system. We have a strong belief in the separation of banking from investment banking and other non-banking activity. That separation is eroded from time to time, but it is still an underlying philosophy of bank regulation. Therefore, a lot of supervisory information we request has to do with non-bank activities--particularly

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those conducted in the U.S. We also have geographic constraints (the so-called McFadden Act constraints) in our regulatory system and these affect foreign bank operations; but that is not particularly a supervisory matter.

2. THE SUPERVISORY FORMS

A. The Proposed Forms

What did the Federal Reserve, in executing its responsibilities under the Bank Holding Company Act and under the International Banking Act, do in recent months to deal with these kinds of concerns? In 1979 the Board put out for comment its Form Y-7. As it was proposed, Form Y-7 would have required very extensive information on parent foreign banking organizations overseas. Time does not permit me to discuss all of the details of what was proposed; but, for example, we would have required from the foreign parent financial statements of various subsidiaries using accounting principles generally accepted in the U.S. We would have required extensive disclosure of the related interests of directors and officers of foreign banks. We would have required extensive information with respect to less-than-majority-owned subsidiaries of foreign banks operating around the world. When we put this proposal out for comment, it was not greeted warmly by the international banking community. However, we felt that we were pursuing "national treatment" and requiring the same kind of detailed information we require from everybody else.

B. Comments on the Forms

The foreign bank commentators had some legitimate points. The comments we received were very helpful. In that regard I want to make a practical point here--particularly for those of you who may be from offshore or representing foreign interests. In my experience, there have been a number of occasions where foreign bankers, and sometimes their counsel, are reluctant to talk to regulatory agencies about problems that the regulatory agency appears to be creating for them. Sometimes they are reluctant to accept the invitation to comment. It seems to be a tradition in some countries that you just do not get on the record with a formal comment or have a meeting with your regulator and argue with him or her. That is not the case in this country. Generally, if a foreign institution has a particular concern it is important that it make a comment. Many foreign bankers tend to rely exclusively on trade associations of one kind or another, which, of course, are very helpful sources of comments. But I am urging that if there is a concern that applies to a specific entity, for heaven's sake make your points. Indeed, comments were made by sixty or so foreign banks and a number of trade associations, including the Institute for Foreign Bankers. We had a few comments from domestic banks, but not very many.

The comments on Y-7 had two general thrusts. The first, which I will dispose of quickly, is that we did not have the authority under the IBA to request all of this information. We felt we clearly did; and nobody has challenged us on that particular point, maybe because we backed off on some of the things we were requiring.

Another area of concern, which was a very difficult one, was that much of the information we were requesting--in terms of financial data and so forth--was not the sort of information foreign banks

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generally disclose to their own regulators, let alone to the public. Foreign banks were unsure whether this material would be granted confidential treatment.

Those arguments were very strongly made and very seriously considered by the Board. Other comments involved various technical problems. For example, foreign banks often cannot use the accounting principles generally accepted in the U.S. They also argued that it is unreasonable for us to try to examine the business interests of their directors; that is just not done in other countries. Many good arguments were made.

The Board considered these comments over quite a number of months and finally approved a new set of forms. These, I think, alleviate most of the concerns that the foreign bankers have raised, while at the same time they give the Board and the other financial regulatory agencies adequate information to conduct their supervisory role.

Let me pause here and make a distinction which sometimes is not made between regulation, the supervisory role, and the examination role. In the banking regulatory business we generally have three functions. First is regulation, stating what you can and cannot do. Second is supervision, which is the monitoring by way of reports and the like of activities of regulated industries. And third is examination, which I would describe as the visitorial power.

A lot of people confuse supervision and examination, and consider them the same thing. I do not think they really are, and I make that point because it is important in connection with the Y-7. The Y-7 is a supervisory form. We are not proposing to take that form, and run over to Frankfurt or Basle or London, and walk in the door, and examine the parent institution. Not at all. The information that we are generating through this form is an alert mechanism. It is something that we would use to see if there are any problems developing year by year. For example, the Y-8f form (another form which has to do with transactions with affiliates) is filed quarterly and is used to pick up information on trends and developments. If we see a problem, we will address it through the usual informal consultation with the banking institution here. There may be some discussion with the parent, and there may be some discussion informally with the home country regulator if the problem is serious. However, no home country visitation is involved.

C. Final Version of the Forms

What did the Board do in respect to the Y-7 and the Y-8f in its final regulations? A summary was made of those forms, together with an additional related form adopted by the Board. All three forms can be obtained from any Federal Reserve Bank or the Board. The summaries are useful in terms of describing what went on in the regulatory process. The system we adopted to accommodate the most serious concern of the foreign banks--the confidentiality problem--was as follows: we divided the originally proposed Y-7 form into two forms. The new Y-7 requires information, in part 1, that would be publicly available to shareholders and the public in the home country. In addition, we are not requiring the accounting principles that are generally accepted in the U.S. In the Y-7 we will accept financial statements prepared on the basis of the accounting procedures that are used in the home country, so long as we have an explanation in the initial filing of the differences between U.S. generally accepted accounting principles and home country principles.

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The second part of the Y-7 form would require various kinds of information on non-banking activities in the U.S. This is no big problem for the foreign banker, since those records would be readily available and would, of course, be consistent with U.S. accounting practices.

3. SOLVING THE CONFIDENTIALITY PROBLEM: The New F.R. 2068

With respect to other, more sensitive financial information, we handled the issue with a new form. For an example of the problem, some institutions have over-draft accounting, and it is very difficult to figure out exactly what are earnings, or what are revenues, or what are expenses. Furthermore, there are so-called hidden reserves in a number of foreign bank operations. The use of hidden reserves is an accounting technique that has the purpose of leveling earnings over time, and it can result in the over-stating of liabilities. We are not able, from a domestic analytical point of view, to figure out these techniques just by looking at publicly available foreign bank statements.

So what we did is construct a new form called F.R. 2068. It is a confidential report on operations. This form we consider to be a bank examination report in all respects; and this is important, because we will treat it as highly confidential under the Freedom of Information Act. For those of you who are not lawyers or are not from the U.S., the Freedom of Information Act causes many problems when it comes to bank regulatory and supervisory issues and forms.

The Freedom of Information Act basically provides that a member of the public can obtain any document that is an official agency document in the possession of a federal agency, unless there are specific exemptions enabling the agency to withhold the information. One of those exemptions, exemption 8, has to do with examination reports. We do not give such reports out to the public, and our action has been sustained in the courts. The courts have given a very wide definition to the term examination report--even including consumer examination reports, where examiners measure a bank's compliance with the Truth in Lending Act, equal credit opportunity statutes, and the like. These reports are deemed confidential examination reports, not subject to disclosure under exemption 8, even though they have very little to do with safety and soundness.

In regard to the confidential portions of the foreign bank reports, we obtained an opinion from the Office of Information Policy of the Department of Justice (the part of the Justice Department which defends Freedom of Information Act suits) that this material may be kept confidential from the public. Of course, if the need is shown, we will exchange this information with other bank regulatory agencies that have a supervisory concern--such as the Comptroller of the Currency, in the case of the federal branch, or the FDIC, in case of an insured state branch. That is done with all examination reports. With respect to other agencies in the government, some of which have enforcement concerns (the Securities and Exchange Commission, for example), we will not automatically give out an examination report to any agency that asks for it in connection with an examination or an enforcement action it may be considering. We ask the agency, and require it, to define its request very narrowly and to justify its need for the information. We do not permit fishing expeditions for information, and we often have long and sometimes heated discussions with agencies that request examination reports.

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So we think we are able to give a good deal of assurance to the foreign banking community that the information in the F.R. 2068 will be kept confidential. We are never in a position, however, to guarantee confidentiality, because courts in this country conceivably could order disclosure if a suit were filed. Nevertheless, I think it highly unlikely that an examination report would be publicly disclosed. It is possible, of course, that examination reports could be subpoenaed during the course of litigation; but if disclosure were ordered it would be under a protective order, so that access to the information would be limited to the court and opposing counsel.

In summary, I think we have eliminated most of the major concerns on the confidentiality side--to the extent we can under our system of law. We have (as described in Appendix II A & B) modified these report forms considerably. These forms--the Y-7, Y-8f, and F.R. 2068--are the principal supervisory forms used by the Federal Reserve with respect to foreign bank operations in the U.S. The reports are due four months after the close of an institution's fiscal year; and the Reserve Banks or the Board would be willing to discuss any specific problem that a particular institution may have in terms of public disclosure and confidentiality. We are very flexible.

For example, in regard to the Y-7 (which is not a bank examination report and does not have the protection that I mentioned with respect to the F.R. 2068), we would entertain a request that certain information, which might otherwise be publicly available or disclosed in that form, not be disclosed, on the basis of another exemption of the Freedom of Information Act grounded on trade and confidential information.

Let me re-emphasize that the U.S., as a host country, is very concerned about the impact of foreign banking operations on our own banking structure. Because of that concern we probably require more information than is perhaps typical of other countries with respect to foreign entrants in those countries.

NOTES

[1] 44 Fed. Reg. 10509 (1979).

[2] 44 Fed. Reg. 44267 (1979).

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APPENDIX II-A

FEDERAL RESERVE SYSTEM

REPORT REQUIREMENTS

ANNUAL REPORT OF FOREIGN BANKING ORGANIZATIONS
FOREIGN BANKING ORGANIZATION CONFIDENTIAL REPORT OF OPERATIONS

[Docket No. R-0256]

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final report forms.

SUMMARY: The Board of Governors of the Federal Reserve System has adopted final forms for submission by foreign banks that conduct a banking business in the United States through branches, agencies, subsidiary banks or commercial lending companies. These forms are the Annual Report of Foreign Banking Organizations, Form F.R. Y-7, and the Foreign Banking Organization Confidential Report of Operations, Form F.R. 2068. The reports replace the current Form F.R. Y-7 which had been filed only by those foreign banking organizations that owned commercial banks in the United States. A proposed F.R. Y-7 was published for comment in November 1979, and in response to comments received the Board adopted the modified Annual Report. In addition, the Board adopted a new report form F.R. 2068. The information collected by these reports is designed to assist the Board in assessing the condition of the foreign banking organization as it may affect its U.S. banking operations. Collection of the reports is authorized by the Bank Holding Company Act of 1956 and the International Banking Act of 1978.

The forms will be filed with the Federal Reserve System annually 120 days after the end of the foreign banking organization's fiscal year. A foreign banking organization whose fiscal year ends during the period from October, 1980 through February, 1981 shall file its initial reports by June 30, 1981. All other foreign banking organizations shall file reports within 120 days of their next fiscal year-end. Form F.R. Y-7 shall be filed with the Federal Reserve Bank of the District in which the foreign banking organization's United States banking business is largest. Form F.R. 2068 shall be filed directly with the Board's Division of Banking Supervision and Regulation. While the reports are intended to provide information sufficient to monitor an organization's condition on an ongoing basis, the Board also reserves the right to require the filing of additional statements and information if such would assist the Board in carrying out its responsibilities.

FOR FURTHER INFORMATION CONTACT: Stephen M. Lovette, Senior Financial Analyst, Division of Banking Supervision and Regulation (202/452-3622); or Kathleen O'Day, Attorney, Legal Division (202/452-3786), Board of Governors of the Federal Reserve System.

SUPPLEMENTARY INFORMATION: The Board proposed the new annual reporting requirement in order to fulfill its supervisory and regulatory responsibilities under the Bank Holding Company Act ("BHCA") and the International Banking Act. The proposed report was intended to enable the Board to determine the organization's compliance with U.S. laws and regulations and to assess the ability of the organization to serve as a source of strength to its U.S. banking operations. The proposed report requested a significant amount of financial and organizational information on the worldwide operations of the foreign banking organization.

Substantial adverse comment was received on the report as proposed. The

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two major areas of criticism were the amount and type of financial and shareholder information requested and the lack of a guarantee of confidentiality for information submitted. In response to the comments received and in an effort to reduce the substantial burden that the proposed report would have imposed, the Board has adopted final report requirements that address these concerns without impairing the supervisory and regulatory usefulness of the reports. Foreign banking organizations will be required to submit two reports on an annual basis, a modified Form F.R. Y-7, and a new report, Confidential Report of Operations, Form F.R. 2068. The reports do not impose additional informational requirements beyond those that were proposed for comment.

Form F.R. Y-7 - The Annual Report is in two sections. Section I requests financial statements that are prepared for disclosure in the home country of the reporting organization together with an explanation of the accounting principles used in preparation of these statements. There is no requirement that the statements be prepared in accordance with generally accepted accounting principles in the U.S. The reporting organization must also submit an organization chart of its U.S. operations, and financial statements for any U.S. nonbanking company that it controls. The report requests that the foreign banking organization provide information on its voting securities, including the number of such securities issued, a description of the voting rights that attach to those securities, and an explanation of home country requirements with respect to registration of bearer securities. The report also requests a list of all shareholders that control five percent or more of the organization's voting securities. Many foreign banking organizations indicated that they do not know the identity of five percent shareholders where the securities are held in bearer form. The report has been modified to require that, when securities are held in bearer form, shareholders need be identified only to the extent that they are known to the foreign banking organization. The proposed report also requested that the foreign banking organization list all shareholdings of its officers and directors in the foreign banking organization and in any U.S. company in which the foreign banking organization controlled more than five percent of the shares. The report as adopted requires reporting of such shareholdings on an aggregate, rather than an individual, basis.

Section II of the F.R. Y-7 requests information on nonbanking activities conducted by the foreign banking organization in the United States. The amount of information requested has been significantly reduced from that requested by the proposed report, in that the organization need not provide an asset, revenue or income breakdown by individual activity conducted by a U.S. company. The information requested by this section is intended to assist in determining an organization's compliance with the nonbanking provisions of the BHC Act and the Board's Regulation K (12 C.F.R. Part 211).

Foreign Banking Organization Confidential Report of Operations Form F.R. 2068. - The new Confidential Report of Operations requests much of the information that was requested in Section II of the original proposal. The proposed report received substantial adverse comment from foreign banking organizations and foreign bank supervisory authorities concerning the lack of assurances with respect to confidentiality. Much of the information requested by the proposed report is not made available by foreign banking organizations to shareholders or to the public, and in some instances is not provided routinely even to home country supervisors. In recognition of the nature of the information requested and the fact that it is not available to the public from any source, the Board has determined to collect the information in the form of a report of operations. The information will be used to enable the Board to carry out its supervisory responsibilities by allowing the Board to assess the impact of the worldwide operations of a foreign banking organization on its U.S. banking business. The Board is of the opinion that the F.R. 2068 is exempt from disclosure under section (b)(8) of the Freedom of Information Act (5 U.S.C. § 552(b)(8)). Board staff has consulted with the Director of the Office of Information Law and Policy of the Department

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of Justice who concurs in the opinion that the Confidential Report of Operations may be withheld under exemption (b)(8). The material collected in the report will be used solely by the Board in its supervisory capacity. However, the Board may, when requested, provide information from the report to another federal or a state banking authority that has supervisory responsibilities with respect to a foreign banking organization. The Board has determined to amend its Rules Regarding Availability of Information to ensure that any information that is shared with another supervisory authority is held strictly confidential.

The Confidential Report of Operations requests an organization chart detailing all foreign companies in which the foreign banking organization directly or indirectly owns, controls, or holds with power to vote 25 percent or more of any class of voting stock. The proposal requested foreign banking organizations to provide an earnings statements in a fixed format. This reporting requirement was proposed because many foreign banks report a single net income figure and do not disclose any revenue or expense items. The Board considers that minimum disclosure of significant revenue and expense items is necessary for any financial analysis that will be done by the Federal Reserve. The new proposal requires disclosure of revenues and expenses *as calculated in accordance with local accounting practices*. This will meet the objections raised by those foreign banks that use overdraft accounting and cannot provide interest revenue on a gross basis. The proposal also requests an explanation or general description of the accounting practices used in the recognition and the timing of revenue and expense items.

The reporting requirements with regard to loan loss experience, gains and losses on securities, and hidden reserves, are essentially unchanged. However, greater flexibility has been introduced by requesting that the information be provided in a suggested format rather than a fixed format. The suggested format calls for beginning balances, additions, deductions, and ending balances. The intent of the suggested format is to avoid the submission of net figures, which obscure the magnitude of the transactions and may distort any trend analysis. The report provides flexibility to enable a foreign banking organization to submit requested information in a manner that will not impose any undue burden.

The remaining information requested by the Confidential Report of Operations is financial data on foreign subsidiaries. In the initial proposal, the foreign banking organization was requested to furnish balance sheets, income statements, and statements of changes in capital accounts for all material foreign companies in which the foreign banking organization directly or indirectly owns, controls, or holds with power to vote 25 percent or more of any class of shares. A company was considered "material" if (1) the investment and advances to the company exceeded 5 percent of the foreign banking organization's equity capital accounts; (2) the company's gross income or revenue exceeded 5 percent of the foreign banking organization's consolidated gross operating income or revenue; or (3) the company's operations resulted in net income or net loss exceeding 5 percent of the consolidated net income of the foreign banking organization. The comments received on this proposal indicated that substantial problems exist with respect to providing this information, particularly with respect to companies in which the foreign banking organization owns between 25 and 50 percent of the shares. The foreign organizations indicated that, as minority shareholders, they did not have access to full financial statements. The Confidential Report of Operations as adopted addresses these objections while maintaining the Board's ability to assess the overall financial condition of the foreign banking organization. The final report requires financial statements on all majority owned, unconsolidated, material foreign companies. The submission of financial statements of unconsolidated, material investments is necessary to allow an analysis of the strength of the foreign banking organization. An additional change deletes the requirement that the foreign banking organization convert the statement to U.S. dollars. The definition of "material" is unchanged from the proposal.

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With respect to investments of between 25 and 50 percent in material foreign companies, the report requires the foreign banking organization to provide financial data detailing the companies' total assets, total stockholders' equity and net income. This information should be readily available to a minority shareholder, and will provide an adequate basis for assessing the exposure to the consolidated operations of the foreign banking organization by the investment.

A foreign banking organization is exempt from filing the Confidential Report of Operations if its U.S. branches and agencies have neither total aggregate liabilities to nonrelated parties that exceed $100 million nor total aggregate nonbank deposits, credit balances and liabilities on acceptances that exceed $10 million. Any foreign banking organization that owns or controls a U.S. commercial bank or maintains a branch insured by the Federal Deposit Insurance Corporation must file the Confidential Report of Operations.

Adoption of Uniform Accounting Principles

The proposal required a foreign banking organization to submit both consolidated and parent-only financial statements including balance sheets, income statements, statements of changes in capital accounts, and statements of changes in financial position. The comments received from the foreign banks focused on the burden imposed by the requirements. While the proposal did not establish uniform criteria for consolidating majority-owned investments, the comments indicated that this reporting requirement implied that the Board was imposing U.S. generally accepted accounting principles on foreign banking organizations in requiring consolidated statements.

In revising these reporting requirements, the Board believes that the establishment of uniform accounting criteria is unnecessary if supplemental data is reported on earnings and reserves, and separate financial statements for unconsolidated, material foreign subsidiaries are requested. This financial information is needed to assist in the analysis of financial statements that are not prepared on a uniform basis.

Timing Requirements

The comments received on the proposal stated that the filing deadline of 90 days after an organization's fiscal year-end did not allow sufficient time to collect financial and other information on worldwide operations and/or translate the information into English. Some foreign banks indicated that financial statements are not available until after the annual shareholder meeting which is usually held from four to six months after the fiscal year-end. The comments generally recommended a filing date of six months after fiscal year-end.

The Board modified the instructions to require submission within four months of the end of the organization's fiscal year. The instructions provide for extensions of time to be granted only on an item-by-item basis. The length of the extension would be based on an assessment of the earliest date when the information can be provided without undue burden or hardship. Experience with current filings by both domestic and foreign organizations indicates that reports are not received until the filing deadline, irrespective of whether the information is available at an earlier date. As adopted, the procedures for granting extensions of time should promote the receipt of some data within a reasonably short period of time.

Tiered Foreign Organizations

In the proposal, a separate report was required of each member of a tiered banking organization. The reports as revised treat a tiered banking organization as a single entity for reporting purposes. The instructions in the reports describe the specific procedures to be followed by tiered foreign banking

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organizations in filing the Annual Report and the Confidential Report of Operations.

Attached are copies of the reports.

Board of Governors of the Federal Reserve System, February 9, 1981.

(signed) James McAfee

James McAfee
Assistant Secretary of the Board

[SEAL]

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APPENDIX II-B

FEDERAL RESERVE SYSTEM

REPORT REQUIREMENTS

REPORT OF INTERCOMPANY TRANSACTIONS FOR FOREIGN BANKING ORGANIZATIONS AND THEIR U.S. BANK SUBSIDIARIES

[Docket No. R-0257]

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final Report Form.

SUMMARY: The Board of Governors has adopted a Report of Intercompany Transactions for Foreign Banking Organizations and Their U.S. Bank Subsidiaries (F.R. Y-8f) for implementation in the second quarter of 1981. The report is intended to provide information on transactions between a United States subsidiary bank and its foreign parent company and certain affiliates of the foreign parent. The F.R. Y-8f is to be filed on a quarterly basis by foreign banking organizations that have consolidated assets of $300 million or more and that own or control commercial banks in the United States.

FOR FURTHER INFORMATION CONTACT: Susannah M. Lawrence, Financial Analyst, Division of Banking Supervision and Regulation (202/452-2741) or Kathleen M. O'Day, Attorney, Legal Division (202/452-3786), Board of Governors of the Federal Reserve System.

SUPPLEMENTARY INFORMATION: The F.R. Y-8f requests information on transactions between a United States bank and its subsidiaries in the United States bank's foreign parent company and its majority-owned subsidiaries (termed "other BHC members") [1]. The information will assist the Board in monitoring intercompany transactions that may have adverse effects on the safety and soundness of a U.S. bank subsidiary of a foreign banking organization and will aid in determining whether a foreign banking organization serves as a source of strength to its U.S. subsidiary bank.

The F.R. Y-8f may be filed on the basis of each U.S. bank subsidiary's intercompany transactions with other BHC members or a consolidated report may be filed on the basis of aggregate transactions between a foreign banking organization's U.S. subsidiary banks and other BHC members. The report should be filed by or on behalf of only the top tier foreign parent company in order to avoid duplicate reporting by intermediate holding companies.

Asset transfers. Section I of the F.R. Y-8f requests information on asset transfers of more than $100,000 between the U.S. subsidiary bank and other BHC members effected during the reporting period. Asset transfers involving loans that were delinquent, nonperforming, or renegotiated at the time of transfer are to be reported separately. In addition, descriptive detail is required on any

[1] "Other BHC members" is defined to include (1) the foreign banking organization parent company (or companies) and (2) all of that company's majority-owned subsidiaried that are neither U.S. banks nor direct or indirect subsidiaries of U.S. banks.

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U.S. transfer that is equal to one percent of the total equity of the bank participating in the transfer or $2 million, whichever is less. This section of the report did not receive extensive comment and remains essentially unchanged. However, comments received indicated that a foreign banking organization would be unable to gather requested information on transactions effected by foreign companies in which the foreign banking organization owned less than 50 percent of the shares or that the organization did not otherwise control. The proposed form defined "other BHC members" to include all companies, through the first three tiers, in which the foreign banking organization owned or controlled 25 percent or more of the shares. In response to the comments, the definition of "other BHC members" has been modified to include all majority-owned companies of the foreign banking organization.

Specific comment was requested on whether the other major organizational grouping, "U.S. bank subsidiaries and their subsidiaries," should be expanded to include U.S. branches and agencies of a foreign bank. Comments on this issue were mixed. Some commenters stated that because the purpose of the report is to monitor transactions between U.S. banking operations and all other operations, in order to assure the safety and soundness of the U.S. banking operation, all U.S. banking business conducted by a U.S. bank, branch or agency should be included within one grouping. Other commenters indicated that a U.S. branch or agency is an integral part of a foreign bank and to include its operations with those of a U.S. subsidiary bank would impair the Board's ability to monitor the transactions of the U.S. bank. After consideration of the comments, the Board concluded that it would be appropriate to continue to include the U.S. bank and its subsidiaries as one major grouping since the primary purpose of the F.R. Y-8f is to isolate transactions between U.S. banks and all other members of the foreign banking organization

Other Intercompany Transactions and Balances. Section II of the proposed F.R. Y-8f requested information on five types of intercompany transactions and balances: (1) U.S. bank subsidiary expenses recognized during the period associated with amounts paid or owed to other BHC members; (2) intercompany liabilities and claims; (3) U.S. bank subsidiary participation in loans originated or syndicated by other BHC members; (4) U.S. bank subsidiary loans or commitments made in connection with credit extended by third parties to other BHC members; and (5) compensating balances. After review of the burden imposed and the purposes of the report, the Board has eliminated the requirement for submission of information on loan participations. The proposal also required that average balances be calculated using weekly balances as of the close of business on each Wednesday falling in the reporting period. As revised, the report requires that average balances be calculated using the last 30 calendar days of the reporting period.

Foreign Exchange Transactions. Intercompany foreign exchange information is to be reported in Section III of the F.R. Y-8f. Under this section, the respondent is asked to report (1) whether any U.S. bank subsidiary (or any of its subsidiaries) has experienced a net realized loss *or* a net unrealized loss on foreign exchange transactions during the period; and (2) whether during the period any U.S. bank subsidiary (or any of its subsidiaries) was a party to foreign exchange transactions with other BHC members at nonmarket rates.

In the original proposal, the Board requested comment on whether, in order to reduce reporting burden, there should be established an amount below which realized or unrealized loss need not be reported. Most comments addressed this issue by suggesting various cutoff points. After considering all comments received, the Board has revised the report to require reporting of a foreign exchange loss only if the loss is greater than one percent of the total equity of the U.S. bank subsidiary, or one million dollars, whichever is less.

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A copy of Form F.R. Y-8f and instructions is attached.

Board of Governors of the Federal Reserve System, February 9, 1981.

(signed) James McAfee

James McAfee
Assistant Secretary of the Board

[SEAL]

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Supervising Multinational Banking Organizations:

RESPONSIBILITIES OF THE HOME COUNTRY

Alain Hirsch

MR. MUNDHEIM: Let us follow through with our hypothetical. Assume that the foreign bank with the U.S. branch or subsidiary is a Swiss bank. Alain Hirsch, a member of the Swiss Banking Commission, will tell us the view of the home country as to its regulatory and supervisory responsibility. After you have done that, Alain, perhaps you will want to raise some questions as to whether or not the demands of the host country for information strike you as reasonable and practical.

MR. HIRSCH: Well, if you will allow me, Bob, I think it would be better for the discussion if I begin with the second part of what you have just described and discuss the problem exposed by Neal Petersen a minute ago. Then, in the second part of my remarks I will consider the responsibilities of the home country, that is, of the parent bank.

1. RESPONDING TO THE DEMANDS OF THE HOST COUNTRY

I think, Neal, that everybody agrees, or could agree in principle, that a parent bank has to be a source of strength to the whole of the banking organization. The problem is, who has to supervise it and how much? I suppose that you would also agree that the branches and subsidiaries of a bank should not be a source of weakness for the parent and accordingly that the parent supervisory authorities have some responsibility over them.

A. U.S. Requirements

Now, let us begin very concretely--with your new regulations. One can start with your form F.R. Y-8f covering transactions between a subsidiary or branch in the U.S. and the foreign parent bank. I think that nobody could object to this form and I understand that nobody has, although it requests a great deal of information from the bank. Of course, it requires the foreign bank to give its whole organizational chart to the U.S. authorities; but that is necessary to see what relationship the U.S. branch or subsidiary has to the whole banking group. So, the whole of Y-8f is, I think, fully pertinent to your supervisory task. It has not been challenged, nor should it be. Perhaps it is a good example, if I may begin with a compliment, for other countries to consider.

The second form you have put out is F.R. Y-7 in its new incarnation. In the workshop we could discuss in some detail, perhaps, whether the entire form is necessary and reasonable; but on the whole, I think that this is not a very hot topic.

The hot topic is quite evidently the third form, this pink colored form F.R. 2068, in which you definitely want to know details of the financial situation of the whole international group. You

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want to determine for yourself whether it is really sound and whether it is really a source of strength for the U.S. branch or subsidiary.

B. Criticisms of the New U.S. Requirements

As I have had the occasion to tell you already, I must candidly say that I think this is going just too far. I emphasize the fact that I am not speaking from the foreign bank's point of view; but rather, it is too far from the point of view of foreign sovereignty. The main concern is that this path, which the American authorities have followed in a modest way, challenges the basic principle that it is primarily the responsibility of the home country to supervise an international banking group. I suggest to you that if this approach were taken by a number of other countries in the world, the supervision of international banks would become impossible.

My main thesis is that what the American authorities have done, they could have done only on the assumption that no other country in the world would be bold enough to do the same. I think it is not rude--I hope it is not--to say that it is a form of legal imperialism to do something which you suppose no other country will do, because if four or five others should do it, it would be unacceptable. This is really the problem, and it is a pity that apparently the American banks do not fully understand it. If you really have not received many objections from the members of your American banking community, it is probably because they do not understand the implications of the form. This could be a bad example for foreign authorities; and foreign states could possibly go further, showing less respect for confidentiality than the U.S. has. This is my first point.

The second point is that this form, and this way of supervision, is probably not a very efficient method for the U.S. because, as you said a minute ago, you have very few means of verifying the accuracy of these figures. Let us not discuss the possibility of taking action toward the international group, if you feel it is going in an unsound direction. Of course, at the end of the day you may close the subsidiary or the branch in the U.S., but this is only if the situation is very serious. If something is wrong, the best answer is to ask the authority of the home country for a discussion. In my opinion, this could have been done without the pink form.

Last, but not least, you have said yourself that the confidentiality of this report is intended, but is not certain. This may be quite disturbing, especially when you said that you would not *automatically* give information to other agencies. Nobody reading the report would understand it that way. I am sure you will try your best not to give out information, but as you said, nobody knows.

2. HOME COUNTRY SUPERVISORY RESPONSIBILITIES

We come now to the point of asking, what would and what could the home country or the home supervisory authority do? If I suggest that you should rely on that home authority, or go to it when something is wrong, it must be on the assumption that the home authority takes its responsibility seriously. Admittedly, this responsibility of the home country is not assumed in the same way in all countries today.

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A few years ago it was quite normal to think that the authority which supervised a parent bank was entirely responsible for supervising all its direct activities abroad--lending directly abroad, and so on. To a certain extent, it also supervised foreign branches, although there were some exceptions, because branches were already being supervised in the host countries. It was admitted, however, that subsidiaries were the concern of the local authorities only, and not the concern of the parent.

It is only a relatively recent development to admit--and quite rightly, of course--that economically a subsidiary is very similar to a branch. It does not make sense for the parent's authority to supervise a branch and to forget about the subsidiary. I do not speak now about some special kinds of subsidiaries which, of course, raise special problems. For instance, there are subsidiaries in which the bank has only a minority holding but where, in fact, it controls the bank; or there are joint ventures where two or three banks together own one bank. Problems arise especially when such joint ventures become important.

But, for a minute, let us forget about these exceptions and think about the normal subsidiary: the wholly-owned or majority-owned foreign subsidiary. Surely, the principle of supervision of these entities by the parent's authority is not universally acknowledged today. In some countries there is still a lack of legal basis for consolidated worldwide supervision by the parent. I understand that this is still the case in France, where they lack any authority to supervise subsidiaries. To a certain extent this is also true of Germany. But in more and more countries, the legal basis exists and the will of the supervisory body is also present.

There are, of course, technical difficulties in supervising foreign operations. The host country also provides supervision--local supervision--for the branch or subsidiary. Certainly, the aim is not just to have additional, competitive, and excessive supervision of the same banking operation. Rather, the idea is to develop rational cooperation between two institutions to verify the condition of these subsidiaries. I think that submission to the supervisory authority of the parent country is necessary in order to have an overall view of the whole banking group. Being able to see it in a comprehensive form, the parent country can apply at least some control to the whole of the banking group.

Again, the rules may be very different in different countries. I understand, for instance, that the American authorities receive rather good consolidated statements from their American banks with foreign subsidiaries; but the authorities do not impose the capital requirement of the American law to all the entities covered by this consolidated balance sheet. In Switzerland we content ourselves with a relatively simple method of consolidation. We think that the capital requirements of the Swiss law should not be weakened by the fact that a bank has subsidiaries in some places where the capital requirements are lower. Indeed, in the case of Switzerland, almost all countries of the world have lower capital requirements. For several years in practice--and formally since January 1, 1981--we have applied to subsidiaries the capital requirements of the Swiss law, which are fairly high (between seven and eight percent of the assets of all the worldwide operations of a bank). This kind of rule has not led, if I am correct, but could lead, to some duplication of regulation. I strongly suggest that the only way to reconcile both governments' legitimate concerns is through cooperation between the home authority and the local authority.

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3. NEED FOR MULTINATIONAL COOPERATION

Let me make one more point about the problem of supervision, worldwide supervision. If the home country is to undertake its responsibilities effectively, it has to have the means, not only to get information, but also to verify this information on a worldwide basis. Here, of course, the problem is how to verify information in a foreign country, and here the difference between supervisory procedures in the U.S. and in Switzerland is interesting.

The U.S. has a system of direct supervision with American officials examining the banks directly, while we in Switzerland, as in other European countries, use private auditors appointed by the banks. These are not completely private auditors. They are chosen from a list established by the federal banking commission, and they are very closely supervised by the authority. These auditors really act in many ways as if they had some public authority: they function through the delegation of public authority to a private company. We are very happy, I must say, with this system. I suggest that this method is the most practicable for controlling banks on a worldwide basis. For an official body to go into a foreign country and inspect on site is generally considered unacceptable by the host state; but private auditing companies may have either subsidiaries or correspondent companies in many other countries. They may even send their own people to examine the subsidiaries of the bank. This would not normally be considered as an act of state and would usually be accepted by the bank and the host government. Worldwide verifying--the examining process in your terminology--is more easily accomplished this way.

Now, two words about cooperation, although I do not want to overlap what Peter Cooke will say. To begin with, if cooperation has to take place, the big problem starts with the initial establishment of branches or subsidiaries. This involves questions of competition and of public benefits. A very important condition for allowing the entry of a foreign bank should be the international standard under which it operates and the fact that it has proper worldwide supervision in its home country. If not, I suggest that it is not possible to replace that lack of home-country control by any form of confidential pink report.

If a bank wants to enter the U.S. or any country, it should be customary to make sure that its supervisory authority controls and supervises it in an accepted international way. This need not mean exactly following the American standard or the Swiss standard or the English standard; but supervision must be provided at an acceptable level and on an international basis. That would solve a great many problems. If we consider offshore subsidiaries, offshore banks, and parent banks in offshore countries, the host supervisory authorities readily admit that they normally do not control the whole group on an international basis. So, without any detriment, I think this requirement would solve a great part of our problem.

I believe the second condition for entry should be that the supervisory authority of the parent country must be ready to cooperate fully with the host authority. Especially, it must be willing to alert the supervisory authority of the subsidiary or branch if the whole of the banking group gets into some kind of trouble or if there is an improper transaction between the subsidiary and the

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parent bank. If we could approach this goal, I think it would create an effective and efficient system of supervision for international banking. Benefits would be realized both from the point of view of the supervisory bodies and also from the point of view of the banks, because duplication and excessive regulations would be avoided. I will end with a question: Do you think that the kind of regulation you have recently adopted in the U.S. is helping or is hindering efforts in this direction?

MR. MUNDHEIM: Before I give Neal Petersen a chance to answer that, I want to be sure I understand the point. You are saying, Alain, that before allowing entry of a branch or subsidiary into Switzerland, you would look at the adequacy of the supervisory regime in the home country of that bank?

MR. HIRSCH: This approach is now developing. We have just begun to discuss it in the Banking Commission in some specific instances. Our law does not provide that foreign worldwide supervision of the international group is a condition for entry; but what is required in our law is that a bank should have proper organization. Now, it seems clear to me that having proper organization for a subsidiary means being properly controlled by the parent and by the supervisory authority of the parent. I am confident that if we make this point we would be supported by the court. Indeed, we have considered this factor in many cases where we were convinced that the supervisory authority of the parent bank was quite adequate. True, we have not yet come to a decision to forbid an entry for this reason alone, but I strongly believe that we are moving towards that possibility.

MR. MUNDHEIM: Neal, is that a possible standard for approving or disapproving branches or subsidiaries in the U.S.? If it is not, is that part of the reason for our governmental attitude that we cannot rely on home country supervision? Is there some middle path?

MR. PETERSEN: I do not know if I disagree in principle with what Alain Hirsch is saying--that considerable reliance should be given to the home country supervisor. I think it is something that perhaps over time we might strive for. I have some immediate problems with it in terms of entry into the U.S. at this time and under existing international arrangements; and I am sure Peter Cooke will expand on that theme. First, I think it would be very difficult for the Federal Reserve or the other bank regulatory agencies to be making public judgments on the adequacy of supervision in other countries.

Second, if you go back to the principle of national treatment in the foreign banking area, you should bear in mind that we are not asking the foreign banks for any more information than we require, for example, of a domestic bank holding company filing Form Y-6--even though the form number is a little bit lower. That leads me to the third point which I will give to you in all candor. This is my personal view and not necessarily the view of the Board of Governors or anybody else. Political considerations in this country would not allow us to adopt the system that Alain Hirsch suggests.

We have a very open country in terms of foreign banks coming in at the moment. They had been somewhat restricted by the IBA, but I think the system is still one of great openness and probably as open as any country in the world. Now, that policy has been under some political attack--often in regard to the adequacy of our super-

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vision of the entities coming in. To illustrate that point, I can refer you to Congressional hearings where the Board testified about its approval of certain acquisitions by foreign bank holding companies. At those hearings many members of Congress raised serious questions about the adequacy of our supervision of foreign banks in this country. Now, this is not a legal problem. It is a political concern--a major one in terms of adopting any approach such as that Alain Hirsch suggests.

The next point I would make is that foreign banks in the U.S. --foreign subsidiaries and foreign branches--now have the same access as any other domestic institution to the lender-of-last-resort and the adjustment-credit facilities of the Federal Reserve. In some instances insured foreign branches have a potential claim, or their depositors have a potential claim, on the FDIC insurance fund. I think it would be difficult to fulfill these roles without satisfying ourselves as much as we can of the overall strength of the foreign organizations.

Finally, I would disagree with Alain that what we are asking for is all that onerous and difficult for a foreign banking organization to come up with--particularly the modified Y-7 and F.R. 2068. It seems to me that it is not a difficult job to file that report once a year and to file quarterly the form Y-8f. So, I would conclude my remarks by saying: (1) I don't think we are being unreasonable. (2) I think it is a proper concern of the host country to require this kind of information for ongoing supervisory purposes. (3) I think it would be very difficult at this time for us to change our approach in any significant way--given the present climate--even if it would be desirable to do so. (4) I think the lender-of-last-resort function, the claim on the Federal Reserve that these institutions may have from time to time, argues for our treating them the same as we treat domestic institutions.

MR. HAWES: Neal, could you react to Alain's specific suggestion about independent verification by auditors? As a general principle, I think it has some interest.

MR. PETERSEN: I imagine it does. Our banking system, as far as supervision is concerned, has been traditionally grounded not upon independent auditors, but upon actual examination and reporting to the bank supervisory agencies. I do not think that we would be comfortable with an independent audit verification at this time.

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Supervising Multinational Banking Organizations:

EVOLVING TECHNIQUES FOR COOPERATION AMONG SUPERVISORY AUTHORITIES*

W. Peter Cooke

MR. MUNDHEIM: We have heard that some of the problems between the host and the home country could be smoothed out by international cooperation. Peter Cooke has been one of the leaders in the effort to develop international cooperation among supervisory agencies. Peter, would you talk a little bit about that approach to the problem?

MR. COOKE: Thank you, Bob. Those of you who just heard Neal Petersen and Alain Hirsch's remarks will realize how difficult it is to foster this international cooperation.

I would like to spend a few minutes talking about the international framework of supervisory cooperation within which the debate about Y-7, and its relation to the operation and supervision of foreign bank branches and affiliates in the U.S. and U.S. branches and affiliates abroad, is being conducted.

1. RECONCILING DIFFERENT LEGAL SYSTEMS

First of all, an obvious remark. You cannot regulate internationally unless you have a governing international law. You can only supervise. International supervisory techniques and agreements on common approaches only become legally based when they are incorporated within different national systems on a consistent basis. This problem of reconciling different legal systems, different regulatory approaches, will pervade my remarks.

A. Domestic Supervision

I want to begin by reminding you of the environment in which international supervision developed. Supervisors are domestic animals, or they certainly were until the 1970s. Then, all of a sudden, spurred on by events like the failures of Herstatt Bank and the Franklin National, supervisors came to a rather salutory perception of the degree to which banking had become internationalized and the degree, therefore, to which supervisory techniques and procedures should also be internationalized.

They realized that there was a supervisory vacuum in the global marketplace and that it needed to be filled. Filling this

* Mr. Cooke's remarks were based on a more detailed paper, *Developments in Cooperation Among Bank Supervisory Authorities*. That paper is reproduced in the Appendix to this chapter.

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vacuum involved two steps: first, the adaptation of essentially domestic supervisory systems to the international marketplace, and second, the need for cooperation among the domestic authorities. There are two ways in which this cooperative effort can be pursued and they can be characterized very clearly, I think, in the work of two groups which are the most active in this field.

B. Steps Toward Global Supervision

The first, and the first in time, was a group which was set up among the supervisory bodies of the European Community. It was called the *Groupe de Contact*, and it set out to meet on an informal basis to discuss supervisory problems within the European Community. It later developed a parallel role, undertaking technical studies for formally constituted bodies within the European Community. The ultimate objectives of the Community are directed towards the harmonization of banking legislation in the affected countries. That particular route is one which seeks to produce, by way of European-based legislation, a convergence of national laws and practices to produce a common system within which banks can operate across national boundaries within the European Community.

The second approach--perforce a more informal approach--is that which is followed by the supervisors of the main industrialized countries meeting in Basle. It is essentially one of informal cooperation. It provides a forum for the formulation of guidelines for international supervision, for personal contacts between supervisors, and for mutual education about each other's systems. Most important, it ensures that at least among the major countries, and I hope more widely as the message is spread, there will be no significant gaps in international supervisory arrangements. This group does not seek to promote harmonization of law or regulation, although it may be--and I would certainly hope that this would happen--that some element of convergence of practice in different countries will come about through a developing perception of each country's best practice.

2. THE BASLE COMMITTEE OF SUPERVISORS

I want to focus my remarks this afternoon on the work of the Basle Committee of Supervisors. What is that committee trying to do? We are trying to exercise an appropriate measure of control over the international banking system. That system needs to be allowed to work so that it can fulfill its function of financing international trade. Although the system must be given scope to develop, it must develop in an orderly manner. A delicate balance must be struck between maintenance of national interests and the freedom of the international marketplace. The real problem with supervising the international business of banks is that if they are supervised too rigidly the banks can just walk away and do their business somewhere else where the supervision will be much less stringent. Hence, the growth of the offshore center, as it is sometimes known, which permits the banking system to escape the fiscal and monetary control regulations of national authorities. Indeed, the growth of the Euro-currency markets in the first instance derived from measures taken by the U.S. authorities for domestic reasons. So, there is a delicate balance here to be maintained.

There are two main strands of the work which is being pursued and the understandings which are being sought internationally. The

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first is what has come to be known as the Concordat. This name is somewhat obscure. It relates, if my history does not desert me, to certain activities of the medieval papacy--which is perhaps not an unreasonable antecedent for modern day banking supervisors.

A. The Concordat

The principle of the Concordat was developed in the very early days of international supervisory cooperation, in the mid-1970s, because there were no established practices relating to the overlapping responsibilities of different national supervisors where banks were conducting business across national boundaries. It sets out guidelines covering the responsibilities of different supervisory authorities for the ongoing supervision of banks where those banks operate in more than one national jurisdiction. It is not, and it was never intended to be, an agreement for the provision of lender-of-last-resort facilities to the international banking system. There should not be any automatic link between acceptance of responsibility for ongoing supervision and the assumption of a lender-of-last-resort role.

The aim of the Concordat, then, is to sustain, as far as possible, the health and safety of the existing structure. It does not set out to rule on the way in which the pieces of that structure should be picked up if it is broken. The Concordat encompasses the following principal guidelines and recommendations:
(1) The supervision of foreign banking establishments should be the joint responsibility of host and parent authorities.
(2) No foreign banking establishment should escape supervision, each country should ensure that foreign banking establishments are supervised, and supervision should be adequate as judged by both host and parent authorities.
(3) The supervision of liquidity should be the primary responsibility of host authorities since foreign establishments generally have to conform to local practices for their liquidity management and must comply with local regulations.
(4) The supervision of solvency of foreign branches should be essentially a matter for the parent authority. In the case of subsidiaries, while primary responsibility lies with the host authority, parent authorities should take account of the exposure of their domestic banks' moral commitment in this regard.
(5) Practical cooperation would be facilitated by transfers of information between host and parent authorities and by the granting of permission for inspections by or on behalf of parent authorities on the territory of the host authority. Every effort should be made to remove any legal restraints (particularly in the field of professional secrecy or national sovereignty) which might hinder these forms of cooperation.

I have gone into some detail on this agreement because it is the cornerstone of all international supervisory cooperation which has been developed since that time. Indeed, it has recently been reexamined and found to be still an adequate statement of the basic approach towards international supervisory cooperation.

Just in passing, I might say that the Concordat has an implication for the operation of the Y-7 Report and associated forms. I have a great deal of sympathy with what Alain Hirsch has said. At the same time, because I try to sit in a position which enables me to see the best sides of everybody's arguments, I also understand the U.S. domestic problems. What is really crucial is that there be

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no infringement by the U.S. authorities of the principles of the Concordat. Thus, the U.S. authorities must recognize--and I think they do--that parental responsibility operates across national frontiers.

On one point, I very much agree with Alain. I too am not sure what the U.S. authorities will do with the information they are seeking from their reports. It certainly would be highly undesirable, in terms of developing and sustaining international cooperation, if every country were to adopt the same procedures as the U.S. I might comment that the objections to the Americans' original proposals which have been expressed by most other major countries might be thought to ensure that those countries would not have the presumption to impose similar procedures, as doing so would only fly in the face of the case they are presently putting to the U.S. authorities. However, before dwelling too long on an abstract debate, I personally feel that the important thing is to see how the matter resolves itself in practice. Often things work out better than one might imagine and I think we should wait and see how it does work out.

B. The Principle of Consolidation

The second major element in the development of supervisory cooperation relates to what I have described as the principle of consolidation, touched on earlier by Alain. That is, the principle that there should be a capacity for the parent's supervisor to understand the totality of a bank's international business, in order to get a proper picture of that institution's overall exposure to risk and its capital adequacy. The consolidation principle is currently being implemented to varying degrees in different countries. The principle has been accepted by all the major countries and has obvious implications for the way in which supervisory responsibilities are carried out in practice.

3. SHARING INFORMATION

In my paper I discuss a number of other aspects of international supervisory cooperation [1]. For the moment, I want to underscore just two aspects; they both relate to information flows. There are two basic problems. One concerns consistency of data.

This is a real headache and will continue to be so, but is an area where everybody is going to have to work very hard to improve consistency. Data gathered by national banking systems for their own national purposes do not generate an adequate basis for producing data on the worldwide activities of most of the major three hundred banks of the world. Harmonizing data procedures and data gathering arrangements is extremely difficult. This is also very costly to the banks and they do not like it very much. I keep telling commercial bankers that I think they should regard harmonization of this sort as very much in their own interests. They should be prepared to produce additional data when it is required, in order to serve their own wider interests by having global information available. Such information will be useful in their own businesses.

The second aspect relates to bank secrecy. A great deal has been said about this subject. Personally, I do not believe that banking secrecy provisions in different countries are an overwhelming obstacle to cooperation among supervisory authorities. It is mostly on the deposit side, the liability side of the balance sheet,

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that the real sensitivity lies. Certainly Alain would agree that this is the case in Switzerland, which is perhaps the arch priest of banking secrecy.

It is important, of course, to know about concentration of deposits, but it is really very much more important to know about the spread of the risks on the assets side of the balance sheet. The major industrialized countries, which include most of the major banks of the world, have looked at this subject in a detailed way over the last year or two. They have concluded that while it cannot be denied that there are problems, these problems are manageable in terms of the broad objectives of international supervisory cooperation. You can get the data that you need in order to consolidate and to understand the extent of the exposure of different banks around the world. Insofar as verification procedures are concerned, if direct examination of overseas branches or subsidiaries by the parent is not feasible or permitted, it can be handled by agreements authorizing the host country supervisor to act as the agent of the parent country supervisor, or through the external audit route. I understand Neal Petersen's reservations about these routes, but in the real world, in international terms, you must accept the techniques available. I would think that most of us would feel that the external audit route for verification of data is generally a pretty acceptable one.

Now, all this cooperation I have been talking about has been in the context of the committee which meets at the BIS in Basle. We are working to develop wider cooperation across the whole world. You cannot, of course, operate a committee with a hundred or so countries, so we have just twelve. We do have gatherings where these agreements and understandings can be disseminated more widely. The federal agencies in the U.S. are organizing a conference in September 1981, in which supervisors from all around the world will meet to discuss all these problems. This conference follows one which we had in London in 1979. In the interim between these conferences, we disseminate within the supervisory fraternity the material we produce in Basle.

4. FUTURE TRENDS

To conclude very briefly, I think that the important thing to realize about international supervisory cooperation is that the international banking system is here to stay. International banking is not going to go away. There is an enormous mass of international business and no matter what changes are made in national bank regulations, the international banking system is not going to disappear, and certainly could not without a great deal of effort on the part of national authorities over a very long period of time. The growth of international banking has been accompanied by evolution of international banking supervision. I think that the basis of good cooperative work has been well established and should have significant impact on the capacity of the supervisory authority in host and parent countries to reconcile the kinds of problems which surfaced a little bit, peeked out from under the carpet, shall we say, in Neal Petersen's and Alain Hirsch's comments.

The number of countries to which this international cooperation is going to be significant is increasing all the time, because more and more banks in more and more countries are coming to have an international dimension to their business. I think the system has

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enormous resilience to withstand shocks and difficulties which may occur. Good supervision all around the world is absolutely essential to maintaining that resilience.

I would like to close by echoing a remark which Bob Mundheim made at the beginning. As the system changes, supervisors have to change with it. Structurally we will see, at least in the international sphere, the closer integration of banking, investment banking, and other aspects of the international securities business. Consequently, the regulation of the banking and securities businesses may also have to be more closely integrated in order to respond not only to the internationalization of the two lines of business, but also to the increasing intertwining of the two.

I would not wish to leave you with the impression that I am over-confident about the capacity of the system to meet all the strains to which it may be subject, but I think it is very much better able to do so than it was a decade ago. I have a little notice on my desk which is a quotation from Benjamin Disraeli, an old nineteenth century prime minister in my country. It reads, "Confidence is suspicion asleep." And so I always wish to be on the guard against being over-confident about the capacity of the system to sustain strain. As my Governor put it in a recent speech, "The trouble with good health is that it is such a precarious state. It can only get worse."

5. REMAINING PROBLEMS

MR. MUNDHEIM: Fritz, did you have a comment?

MR. KÜBLER: Well, there is not much I can add. Before coming here I asked our supervisory authorities in Berlin about their feelings about the present situation. I must say, everything they said confirms what Peter Cooke has told us right now. The system works very well inside Europe, and existing gaps are going to be filled. Germany is aiming at legislation for consolidation. Even at the present moment, German banks, under a sort of gentlemen's agreement with the authorities, come forward on a voluntary basis with information concerning their Luxembourg subsidiaries. So, I would like to raise only two questions.

After having listened to the dispute between Neal and Alain, my impression is that there remains a problem in Europe. The system works well when the countries involved have about the same level of supervision. But what are we going to do with the countries that are not yet at this level--and perhaps will not be for the next decade or decades? I am sure that we are in almost the same situation as the U.S. We just cannot completely prevent them from doing banking in Western Europe.

The second question to which I would like to return is the problem of secrecy. Looking at some of the more recent American legislation--for instance, at the financial privacy act you have adopted [2]--the question arises, shouldn't Europe go a little bit the same way? Of course, it cannot be overlooked that the German supervisory authority is part of the Department of Treasury. This certainly does not mean that all information they receive will go to the Internal Revenue Service. But still, wouldn't it benefit international cooperation in banking supervision if a clearly defined line could be drawn? Legislation could be enacted to specify where information may go and where it has to be withheld. I would be very

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happy to get reactions to this question from the supervisors on the panel.

MR. MUNDHEIM: Neal or Alain, do you want to respond to that?

MR. HIRSCH: The second question is the easy one, I think. We are moving toward legislation establishing the limits on the distribution of information given to a banking supervisory body, especially in the Common Market. The new Common Market text restricts the use of information given by one authority to another authority. Basically, information may be used only for supervision of banking and for nothing else. The only small problem is how to deal with a criminal offense. In some countries the notion of criminal offense is very much broader today than it was in the past. It can mean even a very, very minor offense. So, there are still some problems, but I think on the whole, we are in the clear.

Your first question is the more difficult one. What if a bank coming from a country where the supervisory organization is still weak wants to do business in Europe? I think we should then say, "If you are not internationally supervised in the proper way, then we will look with a very, very close eye to see if you may have, for instance, an independent subsidiary in Switzerland or in Germany." An economically independent subsidiary should not be part of an international group or community which is not properly supervised. In practice, that would mean applying some version of your Form Y-8f but probably even tougher. It seems to me that there is no alternative to this, even if it is difficult to implement it.

MR. COOKE: May I add a comment on those two points? On the question of the countries with less supervision, this is, of course, a vexatious problem. It raises the problem which Neal referred to of discrimination between one kind of national supervisory system and another. This may be, on occasion, very difficult to do.

In our Banking Act of 1979, which is the basis for our present supervisory arrangements, there is a specific provision which requires us to have regard for and be in contact with the supervisory authority of the parent entity of any foreign banking institution which wishes to set up a branch or a subsidiary in the United Kingdom. It is within our powers either to accept or not to accept the adequacy of that supervision as fulfilling a number of the requirements that we otherwise would have to address ourselves. If we do not accept it, then we have the difficult problem which Neal referred to of having to appear to be discriminating against that country by saying that we do not think much of its supervision and, therefore, have to do the job ourselves. That is a difficulty, but at least the problem is recognized in our legislation and we have a handle to grasp in that regard.

On the general subject of the development of international banks around the world from less supervised or unsupervised centers, I think I should say that the major countries are all very clearly agreed on what is the desirable principle here, that you should not allow an entity from an unsupervised center to develop an international business. That is easier said than done. There are countries that have in the last year or two passed legislation authorizing the creation of new banks within territories that are specifically excluded from that country's supervisory regime. Banks that take advantage of this legislation may be consortium banks with entirely respectable parentage, interested in pursuing international business

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from a tax and supervisory haven within a country. But in principle, we are very unhappy about the proliferation of such entities around the world and do our best to stop them from operating worldwide from an unsupervised base. I am sympathetic on the whole to the view that banks should not be allowed to enter a country if the host country bank supervisory authority has forbidden it and where it believes there is no supervision or the quality of supervision of the parent is unsatisfactory.

On secrecy, the second point, I think the particular sensitivities relate to deposits. The other sensitivities of most European countries relate to hidden reserves. This is a subject that is going to be debated fairly hotly in Europe over the next year or two because, as Alain indicated, there is a bank-accounts directive now before the European Community which seeks to settle the basis on which hidden reserves can be maintained. This problem will likely be with us for a long time.

The important point about secrecy is that it should not preclude supervisory authorities from communicating information which is in their possession to other supervisory authorities when this is in the interest of international banking supervision, that is, when it is in the interest of banks generally operating in the countries of the different supervisory authorities among whom this information is being exchanged. I would very much hope that that principle of free exchange of information for this purpose can be enshrined in national laws as it is enshrined in the new United Kingdom legislation [3].

MR. MUNDHEIM: I promised to let Fred Heldring ask a question.

MR. HELDRING: Peter, I was one of those who read your text in hushed silence up in my room this morning. One of the sentences in your report raises a question in my mind. The aim of the Concordat is to sustain, as far as possible, by effective supervision the health and safety of the existing structure; and I am very impressed with all the progress that has been made in that respect. Then you go on to say that the Concordat does not set out to rule on the way in which the pieces of the structure should be picked up if it is broken.

May I ask your opinion about whatever infrastructure is being built upon a similar basis of international cooperation to take care of a breakdown in the structure at one place or another? Do you think there is as much progress in that area as in supervision?

MR. COOKE: You are opening up a very big question which perhaps goes a little bit beyond the scope of today's discussion, although it is obviously very closely related to the ongoing supervisory process. I think that the lender-of-last-resort function in terms of international business is an immensely complex one. I, for one, believe it is important that it should not be made too specific. There is a principle of moral hazard which we should observe in the international banking system. The Governors of the major central banks of the world issued a communique on September 10, 1974, at the most troubled time in international markets, in which they said rather delphically that means were available to deal with any problems that might arise, and I think we should leave it at that.

MR. MUNDHEIM: Alec, you wished to make a brief comment?

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MR. VAGLIANO: Very brief. As an American bank we are, of course, accustomed to a large amount of disclosure; and when it does not affect customers' confidentiality, we are quite inured to that. However, one point that came up today is the possibility that the regulatory authorities in the many jurisdictions in which we do business may move to global supervision, that is supervision of our overall global activities. I would be very concerned that this could eventually lead to inconsistencies and even conflicts where we would be right in the middle. So I would, in that context, support cooperation between the supervisory authorities.

NOTES

[1] *See* 58 to 63 *infra*.

[2] 12 U.S.C. §§3401-3422 (Supp. III 1979).

[3] *See* Banking Act, 1979, C.37, §§19, 20.

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APPENDIX IV

DEVELOPMENTS IN CO-OPERATION AMONG BANKING SUPERVISORY AUTHORITIES

W. Peter Cooke

INTRODUCTION

International co-operation among banking supervisory authorities is a relatively new phenomenon. It emerged in the 1970's alongside the burgeoning international banking activity which had developed significantly in the 1960's and has continued to grow apace thereafter. I will review the growth in co-operation which has taken place during recent years from the particular perspective of the Basle Committee on Banking Regulations and Supervisory Practices which has provided a focal point for that co-operation.

THE NEED FOR INTERNATIONAL SUPERVISORY CO-OPERATION

The internationalization of banking brought about considerable changes in banking systems and in the conduct of banking business. New international markets grew up with their own techniques and conventions and new kinds of risks. The number of international financial institutions grew considerably as banks expanded across national frontiers through the establishment of subsidiaries and branches in many countries to service the needs of their customers--large and small--on an increasingly international basis and to take advantage of the newly created markets. New types of bank were formed, particularly the so-called consortium banks with shareholders from many different countries. New financial centres developed--notably those which are broadly categorized as "offshore" centres--where banks were attracted by favourable fiscal and regulatory environments to conduct a significant part of their international operations. The proliferation of new banks operating across national borders sometimes led to a situation in which foreign branches and subsidiaries of banks in one country operating in the markets of another country fell outside the perceived responsibilities of the supervisory authorities in either country. More generally, the high degree of cross border interbank borrowing and lending through the ever-growing activity ofthe Euro-markets meant that banks became increasingly dependent for much of their liquidity on banks in other countries and on currencies other than those of their country of origin.

Looking back, it is now clear that at the beginning of the 1970's the perceptions and techniques of banking supervisory authorities around the world had not kept pace with these developments. There was in effect a supervisory vacuum in this new global market which needed to be filled. Neither the supervisors, nor indeed the banks themselves, had fully appreciated the degree to which the banking environment was changing in character and the new increased risks involved in international business. Supervisors were still very much domestically oriented within the framework of different national banking systems. Indeed it is difficult now to realize how little contact there was at that time between those responsible for banking supervision in major countries.

MOVES TO DEVELOP INTERNATIONAL SUPERVISORY CO-OPERATION

The banking environment to which supervisors needed to respond was thus changing radically--particularly in those countries where the world's major banks were situated. The events of 1973 and 1974, when a number of banks in different countries failed (notably the Herstatt Bank in 1974) and others experienced serious losses, highlighted this changed environment and precipitated more urgent action.

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In response to these events, the Governors of the world's major central banks took action to allay the concerns about the viability of the international financial system. They issued a statement in September 1974 to the effect that, while it was not practical to lay down in advance detailed rules and procedures for the provision of temporary support to banks experiencing liquidity difficulties, the means were available for that purpose and would be used if and when necessary. At the same time the Governors concluded that a better co-ordination of the surveillance exercised by national authorities over the international banking system was necessary and to that end they created a new standing committee--the Committee on Banking Regulations and Supervisory Practices with members drawn from the Group-10 major industrialized countries and Switzerland.*

The first formative steps to bring together supervisors in major banking countries had in fact been taken two years earlier in 1972 when, at the time of the impending UK membership of the European Community, an informal and autonomous group of those with operational responsibilities for banking supervision in EEC countries was set up. Known as the *Groupe de Contact* its principal aim was, and is, to achieve closer understanding and practical co-operation between the banking supervisory authorities of the Member States. In recent years the Group has also taken on a technical role for the Advisory Committee for Banking Co-ordination (set up under the First Banking Directive of the European Community to advise the European Commission on moves to harmonize the banking systems of the Community and their regulation).

The Basle Committee of Supervisors met for the first time in February 1975. Its first Chairman was Mr. George Blunden of the Bank of England; and I succeeded him in 1977. The Committee has met regularly over the past six years--normally three times a year.

There were two major tasks confronting banking supervisors which became apparent to the Committee. The first was the need to adapt the national supervisory system within each country in order to cope with the wider dimensions of their major banks' businesses. The second and complementary task was the promotion of close co-operation between national authorities in monitoring the activities of the overseas branches, subsidiaries and affiliates of their own banks and the offshoots of foreign banks in their own territories. The Committee has provided a forum over the years in which supervisors can learn of each other's techniques and experience and hear of problems that may be emerging in different national systems and could be of wider concern. It has been particularly valuable in establishing close personal contacts between supervisors in different countries --relationships which in a number of cases have facilitated rapid and effective co-operation between the authorities concerned when banks operating within their respective jurisdictions have experienced problems. More generally, the Committee has worked to develop broad principles with which different national supervisory authorities can be encouraged to conform in settling their own detailed arrangements. It is not, however, a forum which specifically sets out to harmonize banking supervisory arrangements. National systems have grown up with different traditions: some with detailed statutory arrangements, others with more informal and flexible supervisory frameworks; some have comprehensive examination procedures, others do not. In practice, however, members of the Committee have found much to learn from each other and this mutual learning process may well over time produce some convergence between national systems which can only be beneficial. In all member countries the past few years have been a period of considerable activity in the field of banking law and regulation. Most have enacted or are

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* Committee members come from Belgium (and Luxembourg), Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

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preparing major legislation and in every case this legislation reflects, albeit to varying degrees, accords which have been reached in Basle or the incorporation in the national laws of one country desirable features of the arrangements prevailing in others.

THE DEVELOPMENT OF THE BASLE COMMITTEE'S WORK

In the first period of the Basle Committee's work it concentrated on carving out first principles for international supervisory co-operation. They had to be built up from virtually nothing. The first priority was to reach an understanding of the appropriate division of responsibility between national authorities for the supervision of banks' foreign establishments with the object of ensuring that no foreign banking establishment escaped supervision. The general statement of the Committee's views on this subject which was subsequently endorsed by the Governors in December 1975, has become known as the Concordat. I will discuss this in more detail later. The importance of this early agreement cannot be emphasized too much. It represented the first, and a most significant, co-operative step forward, and even if it may have been a step made easier by the pressure of events at the time, it was nonetheless a considerable achievement which laid the foundation for later co-operative efforts. Another matter to which the Committee turned its attention at the outset was how an early warning system of potential problems in national banking systems might be organized. It was concluded that such problems could not in practice be handled through a separate monitoring system operated by an international body. Because of differences in national systems and legislation co-ordination would be difficult and would anyway tend to duplicate national arrangements. Action to counter potentially dangerous situations should thus be taken by the national supervisory authority most concerned in consultation with other countries as appropriate.

As the disturbances to the system lessened and immediate concerns were allayed the Committee settled down to examine the supervisory tools and arrangements that would be necessary to facilitate implementation of the basic guidelines enshrined in the Concordat and to develop co-operation further. A major recommendation was the use of supervision on a consolidated basis whereby the capital adequacy and risk exposure of international banks would be monitored on the basis of their worldwide business. The Committee also began to look beyond the specific type of risk which had underlain the Herstatt crisis (foreign exchange risk) to a detailed examination of other types of risk facing international banks--especially the degree of maturity transformation effected by individual banks and the system as a whole--and the problems of measuring and monitoring country risk.

As the Committee's work progressed substantial efforts were made to involve in the discussion process supervisors from a wider group of countries than those represented on the Committee since it was realized that to be effective, the supervision of international banking activity should be as comprehensive as possible. From the outset a number of the Committee's papers had been circulated widely within the supervisory community for information and for comment, and in 1979 it was decided to provide a forum for this wider group of supervisors to meet and discuss the Committee's work and its conclusions to date. Accordingly, an International Conference of Banking Supervisors was organized by the Bank of England in London in July 1979. It was attended by bank supervisors from about 80 countries, representing Europe (Eastern and Western), North, Central and South America, Africa, the Middle East, the Indian subcontinent and the Pacific basin. A variety of topics was discussed covering many of the principal areas of the Committee's work up to that time, including the division of supervisory responsibility; co-operation between bank supervisors; capital and liquidity adequacy; foreign exchange controls; consolidation; and the role of the offshore centres. This was the first occasion ever on which supervisors worldwide had had an opportunity to meet together, to establish personal contacts, and to exchange views on international aspects of banking supervision.

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The supervisory agencies in the U.S. have already announced that they will be organizing a similar conference to be held in Washington in September 1981 and we hope meetings of this kind may become a regular feature of the international banking scene so that the work of the Committee of Supervisors meeting in Basle may continue to be disseminated to the widest possible audience and the Committee itself may profit from the ideas of those who do not take part in its regular deliberations. Mention has already been made of the work of the *Groupe de Contact* (some of whose members also sit on the Basle Committee). The studies of this Group have frequently made a valuable contribution to the development of subjects considered in the wider forum of the Basle Committee; for example, the concept of consolidating banks' international business to make international supervision more effective was first discussed in the Group. Other regional and more specialist groupings of supervisors have also met from time to time and are being encouraged. One example of these was a joint meeting of supervisors from the Group-10 countries and the principal offshore centres which was held in Basle in October 1980. During this meeting a number of subjects were discussed, including exchanges of information, consolidation and supervisory standards, and procedures for consolidation and supervision--on all of which a community of approach and considerable measure of agreement was achieved.

AREAS OF CO-OPERATIVE ACTION

I want to turn now to a somewhat more detailed description of the principal areas of work to date in the Basle Committee.

A. The Division of Supervisory Responsibility: The Concordat

It is appropriate to begin with an outline of what has come to be known as the Concordat on International Supervisory Co-operation. It sets out guidelines covering the responsibilities of different supervisory authorities for the ongoing supervision of banks where those banks operate in more than one national jurisdiction. It is not, and was never intended to be, an agreement about responsibilities for the provision of lender-of-last-resort facilities to the international banking system; and there should not necessarily be considered to be any automatic link between acceptance of responsibility for ongoing supervision and the assumption of a lender-of-last-resort role. The aim of the Concordat is to sustain as far as possible by effective supervision the health and safety of the existing structure. It does not set out to rule on the way in which the pieces of that structure should be picked up if it is broken. The Concordat encompasses the following guidelines and recommendations:

(1) The supervision of foreign banking establishments should be the joint responsibility of host and parent authorities.
(2) No foreign banking establishment should escape supervision, each country should ensure that foreign banking establishments are supervised, and supervision should be adequate as judged by both host and parent authorities.
(3) The supervision of liquidity should be the primary responsibility of host authorities since foreign establishments generally have to conform to local practices for their liquidity management and must comply with local regulations.
(4) The supervision of solvency of foreign branches should be essentially a matter for the parent authority. In the case of subsidiaries, while primary responsibility lies with the host authority, parent authorities should take account of the exposure of their domestic banks' foreign subsidiaries and joint ventures because of the parent banks' moral commitment in this regard.
(5) Practical co-operation would be facilitated by transfers of information between host and parent authorities and by the granting of permission for inspections by or on behalf of parent authorities on the territory of the host authority. Every effort should be made to remove any legal restraints (particularly in the field of professional secrecy or national sovereignty) which might hinder these forms of co-operation.

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To make the Conçordat fully effective internationally its principles will have to be endorsed by supervisors worldwide. The London Conference in 1979 examined the terms of the Concordat and, although no formal decisions were taken, there was general acceptance of its principles by those participating. The supervisors from the major offshore centres meeting in Basle in October 1980 also felt able to endorse its principles. It should be stressed, though, that the Concordat's guidelines are not fully implemented in practice and certainly not in law, and there remain areas where the division of responsibility is not entirely clear cut and where banking secrecy provisions are to a degree an impediment to its effectiveness.

Despite elements of imprecision--inevitable in agreements on principles when responsibilities are shared--the Concordat nevertheless has become established as a most important cornerstone of international supervisory co-operation. Its operation has recently been reviewed by the Committee who have concluded that it is still soundly based and a valuable aid to international supervision.

B. Consolidation

The second major plank, developed over the past three years, of the Basle Committee's approach to international banking supervision is the principle that banks' international business should be monitored on a consolidated basis.

The Committee made its first recommendation to the Governors on the merits of supervision on a consolidated basis in 1978. The practice of consolidating the totality of a bank's international business permits its capital adequacy and risk exposure to be assessed on the basis of its worldwide business, including that of its foreign branches, subsidiaries, and affiliates. This prevents banks from "gearing up" imprudently on their capital or increasing their risk taking beyond acceptable bounds through the establishment of operational presences in foreign countries where the solvency and other prudential requirements might be less tight than in the parent country. Consolidation in effect provides a clearer picture of a bank's overall exposure to risk and enables parent supervisors to apply their own standards to the monitoring of their banks' business irrespective of where that business is conducted. Consequently it is an invaluable aid to parent supervisors in enabling them to fulfill in practice their responsibilities under the Concordat for the supervision of the solvency of their banks' foreign affiliates.

The Governors have strongly endorsed the consolidation principle and recommended its early implementation. Since 1978, good progress has been made in a number of countries to push ahead with the introduction or extention of supervision on a consolidated basis for their banks' international business, and others have plans to do so. Banks in Canada, the Netherlands, and the U.S., for example, have for several years been required to consolidate their foreign branches as well as significant wholly-owned subsidiaries for supervisory purposes. Japanese banks have been required to consolidate the accounts of their foreign branches for several years and those of significant wholly-owned and majority-owned subsidiaries since 1978. In the United Kingdom new reporting arrangements were introduced during the course of 1979 to cover the international risk exposure of all UK incorporated banks on a fully consolidated basis which should be fully effective by the end of 1981. In December 1980 the Swiss authorities adopted the necessary provisions to formalize the use of consolidated accounts for the purpose of assessing capital adequacy. In Germany the Gessler Commission's study of the German banking system published in May 1979 recommended the consolidated approach to supervision as a means of dealing with the problem of German banks abroad creating so-called "credit pyramids", and legislation is currently in preparation. Further impetus to the adoption of the principle of consolidation in other EEC countries may come in the relatively near future from proposals for a Community directive, recommended by the Advisory Committee at the end of last year, which would make worldwide consolidation for supervisory purposes obligatory for EEC countries. A recent review conducted by the Committee concluded that good progress was being

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made in applying the principle of consolidation but that much still remained to be done especially in improving the availability and consistency of statistics.

C. Solvency and Liquidity

Effective monitoring of banks' solvency and liquidity adequacy lies at the heart of the national supervisory systems. Over recent years supervisors have been concerned at the weakening of capital, or solvency, ratios that has occurred in a number of countries, due in varying degrees to the rapid expansion of international business, a high degree of competition, the erosion of margins, and inflation constraining real profitability. This tendency has been accompanied and reinforced by many banks' reluctance or inability to attract new equity capital and their increasing use of subordinated debt as a substitute--a development accepted rather reluctantly by supervisors.

In an international setting, the need to sustain an adequate solvency profile for banks can be met through the application of the principle of consolidation to a bank's worldwide business without fundamental changes in approach from that pursued at the national level. Up to now the Basle Committee in considering solvency questions has concentrated particularly on attacking the problem through improved consolidation arrangements.

Handling liquidity adequacy questions is more complicated because many currencies are involved and there is no formalized lender-of-last-resort responsibility vested in any one body in international markets as there tends to be for the domestic currency in a national market. The Committee has shared the concern which has been voiced by some that the rapid increase in international lending in the 1970's has been accompanied by a lengthening of maturities and an increased mismatch between banks' assets and liabilities. This gives rise to an interest rate risk and a funding risk, and while in theory the rollover technique should alleviate the first of those risks, banks may not match exactly to rollover dates. In practice also some banks may not be able to re-fund their lending at acceptable rates, particularly when interest rates are rising steeply.

Although there are differences of emphasis among its members, the Committee considers that the degree of maturity transformation effected by banks in their international business is a matter of especial importance to supervisors because funding problems are not infrequently the origin of a problem bank situation. More important, there is the risk that the increased interdependence of banks for their liquidity managment could lead to domino effects throughout the international banking system in the event of problems emerging in one corner of it.

Faced with an inadequacy of statistics in trying to assess the extent of and variations in the mismatching being effected by banks in the conduct of their international business, and in order to be able to make valid international comparisons, the Committee, at the request of the Group-10 Governors, began in 1978 to examine the construction of a uniform reporting system for the collection of data on banks' maturity transformation in their international business. Following extensive discussions, and with the Governors' support, it was agreed in September 1980 that a twice-yearly reporting system should be put in train under the aegis of the BIS with the object of producing aggregated consolidated data on a consistent basis, with fairly detailed maturity breakdowns from sight to 7 years, covering all the international assets and liabilities of reporting banks. This operation began in March 1981. As with other international efforts of this kind, it may take some time for the new system to become fully operational since some countries may have substantially to amend or extend the basis on which maturity transformation data is currently reported; in others it will require a completely new system. But despite such additional reporting burdens for the banks, which for many countries, including the U.S., come on top of recent major revisions to reporting requirements, it seemed to the Committee that it was a matter of considerable priority that better data on this very important aspect of international banking activity should be made available and that these requests for information

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being made to the world's major banks were fully justified. In view of the relatively untried and untested nature of market conventions with respect to liquidity management and further recycling pressures which could well arise in the future, supervisors need to be in a position to improve their capacity to assess the maturity patterns and potential liquidity problems of their banks in the international banking system as a whole.

D. Country Risk

Much has been written about international banks' exposure to country risk. A difficult concept to define with precision, country risk refers to the possibility that borrowers of a particular country may be unable or unwilling to fulfill their foreign obligations because of actions taken by that country's government to conserve foreign exchange reserves or for some other reason. This category of risk, which embraces both sovereign risk lending and lending to commercial entities in foreign countries, has become of increasing concern to banks and supervisory authorities because of the rapid expansion of international lending, particularly to developing countries as part of the recycling process, to a degree which at a time of adverse economic conditions worldwide could call into question the ability of some borrowers to repay their loans as they fall due. The Basle Committee has kept this subject under review over recent years. The basic attitude of supervisors generally can be simply expressed: country risk, as one form of credit risk, is a matter for the commercial judgment and decision of each bank on a case-by-case basis. But as with all kinds of risk exposure in banks' business the essential characteristic is that it should not be excessive in relation to a bank's capacity to meet losses. The supervisors' particular concerns should be: (1) to assist banks to assess the risks they are running by ensuring that the best possible data bearing on the lending decisions is available; (2) to ensure that the banks have adequate internal assessment and control procedures; and (3) to improve prudential reporting and monitoring systems.

A number of steps have been taken over the last few years in line with this approach. Following the Herstatt affair it became clear that an improved statistical breakdown of banks' exposure by country was needed. In 1977 the BIS began to produce twice-yearly data on the maturity structure of the claims of banks in the Group-10 area and certain other centres and in 1979 issued a comprehensive manual on country indebtedness designed to direct the banks to statistical source material for assessing country risk. Many countries' measurement and control systems of this kind of exposure have been improved. For example, in 1978 the main supervisory agencies in the U.S., which have done much pioneering work on methods of country risk analysis, agreed on a common approach to the isolation of country risk, including a checklist of factors to evaluate the banks' ability to monitor and control their country risk. More recently the German and Belgian authorities have asked auditors to include in their annual reports on banks an evaluation of the banks' methods of country risk measurement and control. The U.S. and the United Kingdom are now collecting country exposure information on a consolidated basis. Other countries too are considering similar moves.

E. Other Work

In addition to the work in these major subject areas the Committee has examined a wide range of other issues of concern to supervisors of international banking business. Each meeting gives members an opportunity to keep up-to-date with recent developments in each other's rules and practices and to hear of problem situations and how they have been handled. Subjects that have been studied, or on which recommendations have been made to the Governors, include broad comparisons of the supervisory systems in operation in each country and of various aspects of the banks' own internal procedures to control foreign exchange operations, relations with brokers, official regulations, and the role of supervisors. The Committee has also reviewed the various attitudes adopted by member countries with regard to the role of loan capital in a bank's balance sheet, requirements

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for endowment capital for foreign branches, arrangements for bank audits, and affiliation relationships between banks and non-banks. Other areas of study have included the role of profit and loss analysis in bank supervision; techniques of rescue and support; deposit protection arrangements in different countries; the supervision of banks' trust business; and the prudential implications of certain aspects of loan syndication agreements. In addition, the Committee has been involved with the accounting profession internationally and the International Chamber of Commerce on technical work relevant to international banking business.

F. Information Flows

The free flow of information across national borders between banks and supervisors is a crucial feature of effective international co-operation between supervisory authorities.

Bank secrecy laws or regulations in some countries can enjoin banks not to reveal information about their customers and can preclude supervisors from divulging to other supervisory authorities information that they have acquired in the course of their duties. Obstacles to free cross-border flows of information between foreign offshoots and their parents and between host and parent authorities, while their significance should not be overemphasized, raise a number of practical barriers to fully effective co-operation. First, foreign establishments may not be able to reveal information to their parent banks or the parent bank may invoke the secrecy rules of the host country not to divulge information to its parent authority. Second, host authorities may be precluded by local laws or practice on professional secrecy from revealing information about the banks under their supervision to parent authorities. Third, differences in the laws of professional secrecy applied to different supervisory authorities could potentially make information less well protected in one country than in another. Finally, parent authorities may be prevented from conducting on-the-spot inspections to verify the information they receive.

Since such impediments can clearly impair parental supervision under the Concordat, consolidated supervision, and co-operation in general, the Basle Committee is working to reduce these obstacles but believes that, at least amongst its members, secrecy provisions do not in practice operate substantially to impair supervisory co-operation. In particular, use of banks' external auditors may help alleviate some of these impediments. An important step forward in removing the legal barriers to exchanges of information between supervisors was made in the First EEC Banking Directive, adopted at the end of 1979, which requires Member States to permit the exchange of information between supervisory authorities about the management and ownership of credit institutions and data necessary for monitoring their liquidity and solvency. More recently, there have been signs of a greater willingness on the part of other countries to relax secrecy rules for purposes of international supervisory co-operation. These are encouraging developments in what must be recognized to be a gradual process, since bank secrecy constraints are deeply rooted legal or customary attitudes in many countries around the world and will not be quickly or easily removed.

Another area of concern in ensuring that effective exchanges of information can take place is the consistency of the data. Differences of style and techniques and of intensity of supervision lead to considerable variations in the amount and form of the information required by national supervisory authorities. Much of the information supplied by the banks is designed to meet not only prudential but also monetary and statistical purposes for which information needs differ widely between countries. What is more, during the last few years, as a result of the rapid change in banking and supervisory arrangements in the 1970s, many countries gave considerably amended and generally enhanced their national reporting systems. This has placed burdens on banks and the authorities have to strike a sensible balance between securing important informational objectives and making excessive demands on their banks.

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A start has been made on "international" reporting with the collection of reasonably consistent data on country exposure and maturity transformation. As these reporting systems are improved and consolidation reveals what further co-ordination is necessary on a broader front, it may be hoped that models will evolve on which future changes in national systems can be based. In the meantime, at this experimental stage in the collection of "international" data, the banks--and supervisors--will have to recognize that some duplication of existing systems and allocation of extra resources are inevitable but that these should be borne with for the general good. Over time the Committee will be working to achieve a greater degree of agreement about the purposes which data should serve so that all countries will have a better basis for considering sympathetically the desirability of standardizing systems for the production of such data.

CONCLUSION

The initial moves toward international co-operation in banking supervision in the mid-1970s arose out of problems associated with the rapid growth of the Euro-markets and the strains of international recycling following the first major oil price rise. As the 1980s began, in the light of the continued growth in international business and pressures from further oil price rises, the Central Bank Governors of the Group-10 countries and Switzerland took a further close look at international financial markets and banking activity. They concluded that high priority should be given to the maintenance of the soundness and stability of the international banking system.

To enhance the authorities' surveillance capacity the Standing Committee on Euro-markets was charged with the regular review of international banking statistics and other relevant information. Thus developments in the macro-economic field, which profoundly affect the environment within which supervisors operate in working to sustain the soundness of individual banks, are now being regularly monitored. At the same time, in their communique of April 1980, the Governors referring to the risks run by individual banks re-affirmed "the cardinal importance which they attach to the maintenance of sound banking standards--particularly with regard to capital adequacy, liquidity and concentration of risks. To this end they place high priority on bringing into full effect the initiatives already begun by the Committee on Banking Regulations and Supervisory Practices with regard to the supervision of banks' international business on a consolidated basis, improved assessment of country risk exposure, and the development of more comprehensive and consistent data for monitoring the extent of banks' maturity transformation." Thus, some at least of the tasks of the international supervisory community in the early 1980s have been signposted.

The last few years have seen the emergence of a strong sense of community of interest among those responsible for supervising the international business of banks in full awareness that the health and safety of individual banks now depend on the soundness of the whole international banking system. The knowledge that this co-operation exists provides reassurance to the markets that the international banking system is being effectively supervised and that, should problems emerge, contacts and understandings exist and experience can be shared to ensure that speedy solutions can be found to minimize the extent of any disturbance to the system.

The Basle Committee, and the Contact Group, have played a pivotal role in this process. They have provided a forum for mutual education about each other's systems; for the exchange of confidential information within the bounds of each country's secrecy rules; for the study of individual problems to learn the lessons they contain for supervisors; for the elaboration of guidelines that should govern the supervision of banks' international business; and perhaps most important of all, for the establishment of personal contacts which has led to practical continuing collaboration outside the confines of the committees in an atmosphere of mutual confidence and trust both in routine matters and in individual problem cases.

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The result of these contacts and exchanges has been to create a new international approach to banking supervision. The foundations of international co-operation in supervisory responsibilities have been laid, notably in the Concordat and the recommendations on consolidation. In addition, new international guidelines, frequently incorporating the best of individual countries' experience and developed through international discussion, often in a spirit of real compromise, are coming to be widely accepted by authorities worldwide and are increasingly being reflected in the legislative and administrative measures undertaken by individual countries.

Moreover, in framing new policies many countries increasingly seek possible models in the methods of other countries, and this is creating a slow but perceptible trend towards convergence of supervisory techniques based on best practice. More remains to be done in the 1980s but a basic international framework for future co-ordination and co-operation, both among the major industrialized countries and more widely, has already been established.

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INFLUENCE OF INTERNATIONAL BANKING ON BANK REGULATION IN THE UNITED STATES

Robert Carswell

MR. MUNDHEIM: These questions on supervision could be pursued at length, but it is time to turn to the question of the influence of international banking on bank regulation in the U.S. and ask Bob Carswell, a former Deputy Secretary of the Treasury and presently Visiting Distinguished Practitioner at the University of Pennsylvania Law School, to address those questions.

MR. CARSWELL: Previous speakers have described in some detail the extraordinary net of laws and regulations that the Congress and our small army of federal and state bank regulators have woven in the last few years as a response to the equally extraordinary growth in the international financial and banking markets. Most of the substance of this regulation derives from a decision to retard the internationalization of theose markets by requiring new entrants to play in the U.S. by our domestic rules rather than addressing possible changes in those rules to give domestic banks more freedom to compete against foreign entrants. Since our domestic rules are complex, the technically competent response produced is, not surprisingly, even more complex.

I would like to discuss briefly the context in which this latest round of regulation has proceeded, some of the forces that are operating, and how these forces are affecting several areas of regulation.

1. HISTORICAL PERSPECTIVE

Fifty years ago we had a banking crisis in this country that had profound effects on hundreds of thousands of people and businesses and on our whole economy. Several broad statutes were passed, abuses were corrected and a comprehensive framework of regulations was instituted that had the long-term effect of reducing the areas in which banks could compete and of curtailing initiative in the banking business.

The crisis passed, but in the decades after World War II it became clear that a price being paid for sound banks was that a large share of the growth in our domestic financial markets was going to less regulated financial institutions. A generation ago, there were no significant non-bank commercial lenders, banks had most of a much smaller personal finance and consumer credit market, through their trust departments they dominated a much smaller market for investment advice, the Small Business Investment Corporation and other government credit programs were a small fraction of their present size, and there were no money market funds or brokerage houses offering the equivalent of checking accounts. On the other hand, our larger banks expanded dramatically in unregulated overseas markets, and a large volume of international banking business simply moved out of the U.S.

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A series of panels and commissions appointed by administrations over a twenty-year period all recommended substantial legislative changes to simplify the system, increase competition, and dispense with unnecessary regulation. The Congress failed to act, apparently viewing the area as a dispute among business rivals with little public interest involved in the outcome. It was not until last year when a large number of small consumers complained that the banks only paid them five and one-half percent interest while everybody else was getting fifteen percent or more that the Congress finally responded to some of the neglected agenda. That response, in the form of the Depository Institutions Deregulation and Monetary Control Act of 1980, has begun to redress the balance and restore competition in some areas. But the pace of change will also depend on more general economic developments and, in no small measure, on likely continued internationalization of the financial markets.

2. DEVELOPING POLICY AREAS

This interaction between events and the trend toward deregulation is evident in a number of areas of bank regulation, of which I will touch on three: (1) monetary policy and interest rate control, (2) standards by which to judge foreign acquisitions or control, and (3) equality of competition between domestic and foreign banks.

A. Monetary Policy

Whatever one's views of monetary policy, it seems abundantly clear that control of the money supply will be a crucial element in the domestic policy of most, perhaps all, developed countries. It is equally clear that authorities in virtually all those countries are experiencing a variety of technical and operational problems. In the U.K. critics argue whether the cause of the government's problems is the Bank of England's inability or its unwillingness to restrain monetary growth. The Board of Governors of the Federal Reserve System has faced similar criticism as a consequence of erratic short-term swings in interest rates and the money supply. The necessity of taking action with respect to interest rates to accommodate balance of payments or exchange rate problems, presents similar difficulties. It may be useful to illustrate with a few recent policy dilemmas.

(i) Reserve requirements

In October 1978, the dollar was dropping in a disorderly fashion on the exchange markets and raising concerns that panic conditions might be precipitated in the markets. A joint Treasury-Federal Reserve response was hastily fashioned, relying principally on a large increase in the war chest for intervention, a one percent increase in the discount rate and a two percent supplementary reserve requirement on time deposits of $100,000 or more. The Federal Reserve commented at the time:

> The reserve requirement action will help to moderate the recent relatively rapid expansion of bank credit. It will also increase the incentive for member banks to borrow funds from abroad and thereby strengthen the dollar by improving the demand in Euro-markets for dollar denominated assets.

Whether the action on reserves taken would have the advertised impact was debated by some; others complained that it would have

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inequitable competitive effects. Whatever the precise results, it was evident that the use of reserve requirements in this type of situation was less than a panacea because of the very large size and volatility of the Eurodollar market. Partially in response to suggestions from the Congress, the Federal Reserve (with Treasury participation in the effort) initiated discussions with Governors of the central banks of the Group-10 countries and Switzerland concerning the possible imposition of reserve requirements on Euro-currency deposits. The U.S. tabled a discussion paper; two committees were appointed; but there was little enthusiasm for the idea in Europe in 1978 and 1979, and nothing tangible has come of it as yet.

(ii) Eurodollar market

No one argues that the Eurodollar market does not complicate the Federal Reserve's ability to conduct monetary policy in the U.S. --whether with the objective of controlling the money supply or influencing exchange rates. Large U.S. borrowers have learned to use the Eurodollar market, and their access to foreign banks is clear enough. Thus, efforts by the Federal Reserve to restrict credit domestically will be effective only to the extent the Eurodollar market rates and movements parallel those of our domestic markets. Governor Wallich has pointed out that frequently they do. But he concluded in testimony in July 1979, that the thrust of his discussion was to recognize that "the existence [of the Euro-currency market] makes the execution of monetary policy more difficult."

(iii) Inflation curbs

In March 1980, the U.S. announced a series of monetary and credit actions as part of a general government program to help curb inflationary pressures. They included a Special Credit Restraint Program that specifically included credit extended to U.S. residents by the U.S. agencies and branches of foreign banks. The Federal Reserve also stated: "The parents and affiliates of those foreign banks are urged to cooperate in similarly restricting their lending to U.S. companies." Foreign banks generally were asked to respect the substance and spirit of the Credit Restraint guidelines in their loans to U.S. borrowers or loans designed to support U.S. activity. A panel of large U.S. corporations was asked to report monthly on their borrowings abroad. There is no public assessment of the results of this effort to control the extension of credit by foreigners to U.S. persons.

It is also worth noting that the Federal Reserve currently imposes a three percent reserve requirement on certain Euro-currency activity pursuant to authority granted in March by the Depository Institutions Deregulation and Monetary Control Act of 1980. They are

- net borrowings from related foreign offices;
- gross borrowings from unrelated foreign depository institutions;
- loans to U.S. residents made by overseas branches of domestic depository institutions; and
- sales of assets by depository institutions in the U.S. to their overseas offices.

It is clear enough that these requirements alone will not control the potential influence of the Euro-currency market on our domestic money supply.

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(iv) Future trends

These illustrations represent, in gross, a groping by the Federal Reserve to cope with the real or potential influence of the Euro-currency market on its ability to carry out domestic regulatory responsibilities. These efforts will almost certainly continue. The dollar will have problems again, and it would take unbridled optimism to believe that the course of monetary policy will run smooth. More likely, the influence of the international markets will increasingly impinge on domestic policy and lead to responses both in the U.S. and in other countries. These responses could come through international agreements or cooperation, or they could come through exchange or other types of controls or reserve requirements with varying degrees of effectiveness.

B. Standards for Judging Foreign Bank Acquisitions

A second area where regulatory policy will be significantly influenced, perhaps shaped, by market and economic developments is the standard by which regulators will judge acquisitions, or control, of U.S. financial institutions by foreigners. With the Euro-currency market continuing to expand at a rate at least twice that of the U.S. market and with foreign banks increasing their share of that market, foreign banks should have no particular problem about resources with which to expand.

(i) 1980 moratorium on acquisitions

The moratorium imposed by the Depository Institutions Deregulation and Monetary Control Act of 1980, followed by the call for an additional moratorium by the General Accounting Office in August, indicates sensitivity in various quarters about the standards now being applied. The result--whatever it may be--of Midland Bank's proposal to acquire Crocker National may well trigger either a Congressional reaction or early preemptive foreign acquisitions. Perhaps the most critical but unpredictable influence on foreign acquisitions will be the general health of our banking system.

Most of the completed foreign acquisitions have involved banks that were on the verge of failure, or at least in need of infusion of capital. As previous speakers have pointed out, under present law the only available saviors of larger troubled banks may well be foreign institutions. If general economic conditions lead to an increase in the number of sizable banks in trouble, there will be pressures for a continuing permissive attitude toward foreign acquisitions. On the other hand, there will also be pressures from some domestic banks for modifications in the McFadden Act or the Douglas amendment to the Bank Holding Company Act to permit domestic banks to make the same acquisitions as foreign institutions.

(ii) Extraordinary Assistance Bill

In March of 1980, the bank regulators agreed on the text of an Extraordinary Assistance Bill of 1980, which was introduced as H.R. 7080 and S. 2575 in the last session of Congress. That bill included a provision that would have permitted across-state-line acquisitions by domestic banks in troubled bank situations if the appropriate regulator could make necessary findings. The effect of that bill would be significantly to reduce the foreign bank advantages in these situations. If the economic storm clouds thicken, that bill (or some derivative of it that liberalizes the McFadden Act or modifies the Douglas amendment) will doubtless be introduced. The severity of the problems encountered will have as much to do

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with the outcome as the conflicting public policies involved.

The overall public policy issue remains the question of what standard is the appropriate one for judging foreign acquisitions. Because of the limited presence here of many foreign banks and the present state of the law, the applicable standards can properly be characterized as permissive. But it would be hard to find a Congressman who would feel comfortable about permitting the takeover of one or two of the five largest banks in the U.S.

(iii) Possible tests

What kind of test would articulate that unease but not amount to mere market protection? Neal Petersen has mentioned two candidates that have been under discussion: first, an objective test--probably prohibiting acquisitions involving more than some relatively high percentage of assets in some relevant market. That test would have the virtue of being predictable of result, but the impact in various sections of the country, depending on the percentages and markets chosen, would be widely disparate. Second would be a subjective test, such as prohibiting the acquisition value unless the regulator can find that public benefit could be formulated. Predicting what that kind of test really means would be hazardous. Depending on how it was applied, it would no doubt lead to charges of discriminatory action and perhaps lead to retaliation abroad.

I doubt that it is particularly profitable to try to answer this question in the abstract. A few more clear fact situations would clarify a lot of minds. Since it will likely take a year for the regulators to act on any major proposed acquisition, the Congress will have ample time to react before its consummation. That fairly obvious procedural framework will, I hope, lead foreign banks to proceed circumspectly.

C. Equality of Competition Between U.S. and Foreign Banks

The third area where pending events will continue to impact bank regulation is that of the so-called level playing field or equality of competition between U.S. and foreign banks.

My personal conclusion about this area (with the exception of the advantages foreign institutions have as to acquisitions) is that the substantive inequalities do not now bulk very large. They achieve prominence largely because various aspects of inequality are thought to be excellent reasons to present to Congress or the regulators to justify expanded (and usually highly desirable) powers for domestic banks.

(i) Geographical limitations

Revisions of the McFadden Act and the Douglas amendment have been overdue for a decade or more. The tardily released Report to the President, *Geographic Restrictions on Commercial Banking in the United States,* contains moderate recommendations for change in this area. It notes that, as previous speakers have pointed out, foreign banks have limited advantages in operating across state lines, but it does not rely heavily on this anomaly. As Steven J. Weiss has pointed out in his paper, *The Competitive Balance Between Domestic and Foreign Banks in the U.S.,* the substantive impact of this privilege does not appear to be important.

The geographic advantages are of two varieties. First, grandfathering of the branches and other non-home state operations a foreign bank had prior to July 27, 1978; and, second, the right to

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establish non-home state branches or agencies with limited deposit-taking power if the establishment is not prohibited by state law. Forty of the fifty largest non-U.S. banking organizations have grandfathered deposit-taking facilities in at least one state and twenty-seven in two states or more. Those not grandfathered can establish new facilities with only marginal additional restrictions. The open question is whether domestic banks through Edge Act or loan production offices and the like can achieve approximate competitive status. Clearly they cannot with respect to receipt of retail deposits, but the foreign banks have not developed, and as a practical matter probably cannot develop, extensive retail deposits through their non-home state facilities. The other advertised advantages also appear very limited, with the result that although the technical inequality unquestionably exists, the likelihood of it commanding Congressional attention does not seem high.

(ii) Non-banking activities

Similarly, in the Glass-Steagall area foreign banks command competitive advantages. Under the IBA grandfather provisions, various foreign banks are authorized to continue to retain their interests in thirty-two U.S. firms that engage in various aspects of the securities business in the U.S. The regulators are still engaged in compiling data on the extent of the business conducted by these firms, but the list of U.S. securities affiliations of foreign banks in the Appendix to the Weiss paper is a very long way from a roster of *Who's Who* in the securities business.

The best guess seems to be that the present situation does not grant significant competitive advantages and is a long way from a challenge to the principles underlying Glass-Steagall--whatever they may be. The same general conclusion, namely that significant competitive advantages do not appear to be present, seems to flow from the fact that the IBA permits foreign banks to hold interests in types of non-banking entities that are off limits to U.S. banks. However, there is a potential in both these areas for unfair competition and undue concentration, and no doubt the area merits and will get regulatory surveillance so long as the inequalities are continued.

(iii) Funding costs

The area of funding costs is more difficult to assess and bankers occasionally point to possible inequalities there. Weiss finds little evidence to support the assertions, but it may well be that the effect of reserve requirements can be discriminatory, particularly when foreign banks have great potential flexibility as to where they book business. The ebb and flow of regulations would seem likely to change this area from time to time, particularly if the Federal Reserve response to its problems with the money supply is to increase the ambit of its regulations.

(iv) Export trading

There is one final area worth noting. And it is one where the Congress may be moving toward a liberalization of the powers of U.S. banks, not so much for the purpose of permitting them to compete on a more equal basis with foreign banks--although it would have that effect--but to enhance the export potential of the U.S. The Export Trading Company bill, which passed the Senate 77-0 last year under the guidance of Senator Stevenson, has been reintroduced by Senator Heinz as S. 144 and reported out unanimously last week by the Senate Banking Committee. The heart of the bill would permit U.S. banks to

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invest up to five percent of capital and surplus in export trading companies without federal regulatory approval but would require approval of investments where control was acquired. The trading companies would have broader powers than are now available to banks to facilitate exports--powers modeled on, although more restricted than, highly successful export companies that exist in many foreign countries--particularly Japan.

The Board of Governors of the Federal Reserve System last year opposed the acquisition of control by a U.S. bank on the ground primarily that the activities are not sufficiently close to U.S. bank powers, and the bill did not emerge from committee in the House of Representatives. The new administration has announced its strong support of the bill, including antitrust exemptions contained therein. Chairman St. Germain of the House Banking Committee has not taken a public position, but there have been reports of discussions designed to work out a compromise.

Although it affects a somewhat peripheral area, this bill represents a current illustration of the difficulties our system has in adjusting its domestic regulatory paternalism even to the realities of the largely uncontrolled area of financing and facilitating exports and trading abroad. It will be instructive to watch whether the breezes of deregulation reach this area.

(v) Future trends

How these issues will be decided depends, in part, on the health of our banking industry. If we have a significant number of bank failures the administrators have already agreed on the form of a bill (introduced last year as H.R. 7080 and S. 2575) that has provisions to permit crossline acquisitions--that is, cross state line and cross other boundary line acquisitions by domestic banks in a way that would perhaps parallel what the foreign banks can do today. If this approach is followed, the pressure may let up here, because there will be competition from larger and stronger domestic banks to make acquisitions that presently cannot be made in troubled situations except by foreigners. This development would be healthy for everyone, but apparently it is not going to take place until we have real trouble in our system. Unfortunately this is not the right way to pass considered financial legislation.

The level playing field concept has largely developed into a debate between the various people on the playing field. Depending on what premise you start from, there is, or is not, substantive equality of competition; in most areas the point is arguable. I imagine that Alec may disagree with me, but I think there is more of an effort to influence the Congress to change the division of markets, rather than any desire to right competitive balances.

MR. MUNDHEIM: Alec, I will give you a chance to respond if you like, and then Peter has a comment.

MR. VAGLIANO: Not so much a response, but an observation. I think the question is really so much broader because the industry itself is in the process of a pretty dramatic change that will extend over the next fifteen years. This is brought about by a number of factors that are perceivable today: the narrowing of margins; the competition, as was mentioned earlier, from non-banking sources such as commercial paper and nationwide brokerage; the dramatic increase around the world of non-interest costs, both in terms of employee fringes and even the availability of employees in many places;

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the entirely new technology, which has not yet been able to resolve other cost problems and has in fact added costs and put a great deal of stress on banks; and finally, the tremendous volatility of markets in an inflationary context where even the most prudent and conservative types of institutions like savings banks find themselves in great difficulty because of this dramatic change. I think, overall, you have so many factors working for rapid change that the risks are much greater, and these risks may end with some unfortunate developments. Then you are going to have to push more and more towards regulation, maybe--as Bob was just saying--in the unfortunate context where people do not have the chance to think through the problem and develop coherent long term policy. So I think there is going to be a lot of hit-and-missing going on.

MR. MUNDHEIM: Peter. . . .

MR. COOKE: Just a brief comment. Bob Carswell asked what had happened to the debate on the reserve requirements in the Euromarkets. He said it seemed to have disappeared. Well, it has disappeared, but with a flourish in the form of a communique that the central bank Governors issued in April 1980. It did not refer to reserve requirements as such, from which one can perhaps make certain deductions about the way the debate came out. But it did say that it recognized the need to have regard for the macro-economic environment in which the international banking system was doing its business and to enhance the existing capacity to monitor and keep an eye on that macro-economic environment, re-emphasizing the role of the Euro-currency Standing Committee which, like the Committee of Supervisors, meets in Basle on a fairly regular basis.

These are separate meetings: one group looks at the macroeconomic environment in which international banks conduct their business, while the other, the supervisors' group, looks more at what I would call the micro-prudential elements of each individual bank's business and their inter-relationship. In between these two aspects is what I would describe as the macro-prudential dimension that is somewhere between macro-economic and micro-prudential. This calls for a certain amount of co-ordination between the work of the two groups.

As I see it, the macro-prudential encompasses all issues, like inflation or other macro forces that actually have a direct impact on the way in which an individual bank conducts its business. So the central bank Governors have not actually lost sight of the overall issues that were being addressed in the context of reserve requirements on the Euro-markets. That work is being continued on a regular basis.

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Lessons from the Iranian Experience: NATIONAL CURRENCIES AS INTERNATIONAL MONEY

John E. Hoffman, Jr. and Ian H. Giddy

MR. MUNDHEIM: We are ready now to look at the U.S. government freeze of Iranian government assets and some of the implications that action has for banking and lending policies and practices. John Hoffman, who, as counsel for a major bank, played a leading role in the negotiations which resulted in the release of the hostages held in Iran and in the unfreezing of a substantial portion of the Iranian assets held by U.S. banks, will begin our discussion.

1. THE IRANIAN EXPERIENCE

MR. HOFFMAN: It is fair to say that from the very imposition of the Iranian asset freeze, attention focused on the question of the consequences of the freeze and the lessons to be learned from the experience, wholly apart from the question of the effectiveness of the freeze as a means to compel the Iranians to perform in a way satisfactory to the U.S. government.

There was a great deal of consideration given to the potential effect of the freeze on the foreign exchange markets and the money markets. The announcement of a threat by Iran to withdraw its deposits from the U.S. banking system had been one of the factors that triggered the freeze. Ironically, the question arose, would imposition of a freeze have the consequence of influencing withdrawal of other foreign deposits from U.S. banks? Would Eurodollar deposits, particularly in branches of U.S. banks overseas, become a sort of endangered species as a result of this exercise?

As a result of the experience with Iran, we now know more about the nature and liquidity of the Eurodollar market, as well as the risks of placing and receiving Eurodollar deposits within that market. These and other issues that made up the financial backdrop of the Iranian experience will be the subject of our discussion.

A. Imposition of the Freeze

To set the stage, let us turn back to November 1979. You will recall that on November 14, 1979, President Carter imposed a freeze on certain Iranian government and government-related assets. I think it is worth taking a moment to read the presidential announcement. It states: "I, Jimmy Carter, President of the United States, find that the situation in Iran constitutes an unusual and extraordinary threat to the national security, foreign policy and economy of the United States and hereby declare a national emergency to deal with that threat. I hereby order blocked all property and interests in property of the government of Iran, its instrumentalities and controlled entities in the Central Bank of Iran which are or become subject to jurisdiction of the United States, or which are in or come within the possession or control of persons subject to the jurisdiction of the United States." [1]

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At the same time as the Presidential Executive Order was issued, the White House put out a press release further describing the action this way: "The President has today acted to block all official Iranian assets in the United States, including deposits in United States banks and their foreign branches and subsidiaries. This order is in response to reports that the government of Iran is about to withdraw its funds. The purpose of this order is to ensure that claims on Iran by the United States and its citizens are provided for in an orderly manner. The order does not affect accounts of persons other than the government of Iran, the Central Bank of Iran, and other controlled entities. The precise amounts involved cannot be ascertained at this time but there is no reason for disturbance in the foreign exchange or other markets." [2]

The imposition of a freeze of this nature was not a novel exercise on the part of the U.S. government. There were precedents for the regulations that were issued that day to govern the nuts-and-bolts operation of the Iranian freeze. These precedential situations involved Cuba and China as well as other countries. [3]

What did the freeze purport to affect? What was its desired effect, financially and economically? Prior to this time, Iran had been receiving approximately fifty million dollars a day in oil revenue. These funds found their way into deposits that were maintained by Iran with U.S., European, and Japanese banks. Many of these deposits were denominated in dollars at branches of U.S. banks overseas, predominantly in London. These accounts were a prime target for the freeze.

B. Attack on the Freeze Outside the United States

The question of the President's authority to freeze the accounts very quickly became the subject of litigation in London and in Paris. Within two weeks of the imposition of the freeze, the Central Bank of Iran sued five American banks in London (with which it maintained very large dollar deposits) claiming its right to immediate payment of the funds, asserted to be more than three billion dollars in Iranian external reserves. The Iranian complaint was very simple. It stated that Iran had maintained the deposits, that they were now due, that they had been demanded, and that they had not been paid. In effect, Iran came in with a summary judgment application, which said that somebody owed them some money and would not pay it.

C. Defense of the Freeze

The defenses asserted by the banks in these actions were premised on three main theories. One of them, which will be the primary focus of our attention this afternoon, derives from the operation of the presidential freeze. The freeze defense was based on the proposition that the President could freeze dollar deposits maintained on the books of an American bank branch overseas by the imposition of an executive order, without necessarily intruding into the sovereignty of the foreign country where the branches were located or creating a conflict with the laws of that country. More of this in just a moment.

The second line of defense, which was founded on a public policy argument, held that the courts of England should not honor the Iranian claims because they had behaved in a barbaric fashion and had violated the law of nations. A third defense, based on the Breton-

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Woods agreement, would deny Iran the right to recover on the accounts. I do not propose to spend any time discussing the second and third lines of defense, as most of our attention was focused on the first line of defense: namely, the way in which the freeze affected the Eurodollar accounts.

I should mention that the banks all had substantial setoff claims against the deposits, based on their claims against Iran for various loans. Another issue that played a major role in the litigation in Paris involved the proposition, under French law, that if an American bank were precluded, by virtue of some legal problem in the U.S., from paying out dollars from a dollar deposit in France but was not precluded from paying in francs, it had an obligation to convert the dollar claim of Iran into francs. That issue has not yet been resolved and it is doubtful, at this point, that it will be.

I would like to focus our attention on the defense of the American banks based on the operation of the freeze. From a legal and a tactical point of view, it appeared preferable to structure this defense on the premise that the manner of operation of the accounts was well known to the depositor, who understood that no transfers could be made out of a dollar deposit account in London unless the transfers were made through the New York clearing system. Recognition of that fact was, indeed, a term of the contract of deposit. President Carter had therefore acted within the territorial jurisdiction of the U.S. by freezing the ability to transfer the dollar accounts. According to this theory, the freeze would not create any conflict with the laws of England or English national rights.

This was a defense that was to be established by proving the long term method of operation of such accounts. The defense, however, was not tried in the English court, nor will it be, due to the settlement reached in the Algerian accords. This experience provided a crash course for many people in the nature and operations of Eurodollar accounts. I would like to turn to my colleague, Ian Giddy, who will describe in greater detail how the English courts would have come out on this issue had they had the chance.

2. EURODOLLARS AND THE INTERNATIONAL PAYMENTS SYSTEM

MR. GIDDY: This is a story about the Eurodollar market, how transfers are made between banks in the Eurodollar market, how in 1979 Bank Markazi, Iran's Central Bank, expected to receive return of its funds in London despite the deposit freeze, and why it did not. This is also a story about the Eurodollar transfer system and the implications of the freeze for the future of the international payments and the Eurodollar market.

A. Nature of Eurodollars

First, a little lesson in money. One of the initial questions that was asked of me as a consultant to Shearman & Sterling and another law firm in the Iranian deposit freeze case was, are Eurodollars money? And if so, what kind of money? Fortunately, I never had to give the answer in court. But in the professional writing on this subject, most economists agree that Eurodollars are not *money*, strictly defined. They are more akin to what economists define as *quasi-money*.

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The difference is simply that you cannot make a payment with quasi-money; you first have to convert it into something else. Let us get back to the question of what a Eurodollar is, if it is not money.

Eurodollars are bank deposits denominated in dollars outside the borders of the U.S., and Euro-currencies are bank deposits in currencies other than that of the country in which the bank or bank branch is located. There is nothing special about the deposits. They are mostly time deposits. They are simply deposited outside the country of the currency in which they are denominated.

The important feature of Eurodollars is that they are subject to different jurisdictions and, therefore, different regulations. The *sine qua non* of a Eurodollar is that the regulations to which Eurodollar deposits are subject are less onerous, creating lower costs for the banks issuing those deposits. Those lower costs enable the bank to offer a higher interest rate on the deposit, which is what attracts funds out of national markets and into the Eurodollar market.

B. Risks of Holding Eurodollar Deposits

The higher interest rate, though, does not come free. In the Eurodollar market it is accompanied by a different set of risks faced by depositors who place their funds there. Those risks are fairly well understood by depositors, central banks, domestic corporations, and multinational firms. Those risks were fairly well understood, that it, until the Iranian deposit freeze took place; then a new kind of risk was highlighted.

* CONDITION OF BANK
* CENTRAL BANK BACKING
* HOST COUNTRY POLITICAL RISK
* TRANSFER RISK

Exhibit I: EURODOLLARS DEPOSIT RISK

Exhibit 1 lists four sets of Eurodollar risks. These risks include, first, the condition of the bank itself. The second risk arises from the nationality of the bank, or more accurately, the reliance that one can place on the central bank backing it up. One would normally prefer to have a deposit in a bank that has access to the same currency as the one in which the deposit is denominated, which is why American banks have had such an advantage in issuing dollar deposits abroad. The third risk is the host country's political risk or the sovereign risk--in other words, the risk that the Bahamian authorities might freeze up all Eurodollar deposits in Nassau and that the dollars might not be repaid. One could answer that the dollars are not really in Nassau so they can always be repaid; but this is not as clear cut as it seems because, after all,

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there have been instances of countries seizing foreign banks. This occurred, for example, in Saigon and Peru. In some cases, depositors lost their funds entirely, and even those who have recovered their money have suffered extended delays.

The new element of risk is the transfer risk, which arose out of the deposit freeze. The transfer risk stems from the fact that Eurodollars themselves are not narrowly-defined money. They are quasi-money. People do not make payments with Eurodollars. People make payments with U.S. dollars, which means that they make payments through the U.S. banking system. Thus, despite the fact that the Carter deposit freeze applied only within the jurisdiction of the U.S., it effectively applied not only to the assets held within the U.S., but also to the offshore deposits denominated in dollars in U.S. banks in London, in Paris, and elsewhere.

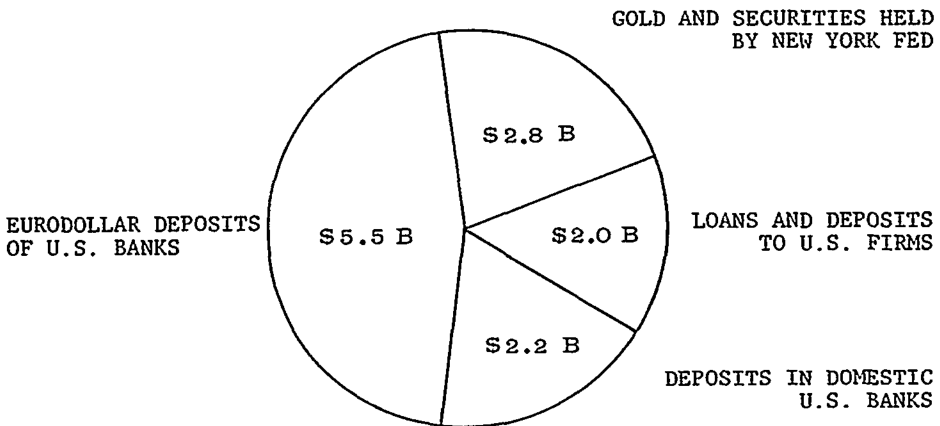

Exhibit 2: OFFICIAL IRANIAN ASSETS FROZEN ON NOV. 14, 1979

Let me refer you to Exhibit 2. Assets of approximately $12 billion were effectively frozen on November 14, 1979. This sum includes gold and securities held in the Fed and the U.S. Treasury (which, of course, were immediately seized), loans and deposits in U.S. firms, and about $2 billion of deposits in U.S. banks. However, about half of the total--for us the more interesting part--was the $5.5 billion in banks abroad, mainly in London, mainly in five U.S. banks.

C. International Dollar Payments System

How was that effectively frozen? Bank Markazi claimed that it was not frozen at all and wanted its money back immediately. Exhibit 3 indicates how the U.S. and international dollar payments system

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works and how Bank Markazi would have received its money. The dollar payments system works quite simply as follows.

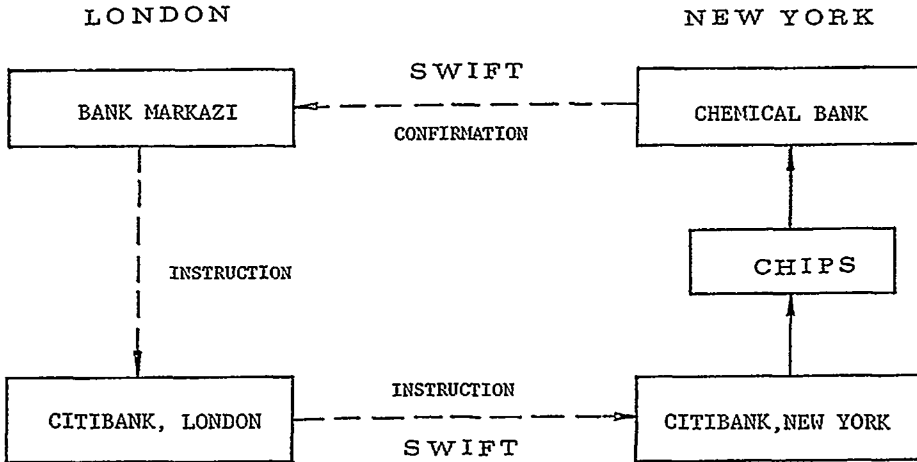

Exhibit 3: THE INTERNATIONAL DOLLAR PAYMENT SYSTEM

Bank Markazi is in London and the dotted line is the demand it put to Citibank and to other banks in London that it wanted its money back--the dollar deposits held in London. It said, "Give it back here in London. It is not in the United States."

A payment between two banks in London, however, is made in New York. This situation puzzles a lot of people including economists, but that is the way it works. To make a payment, Bank Markazi sends an instruction to Citibank in London specifying the amount and exactly which account the money is to be paid into. That specified account is an account in New York, for example, in Chemical Bank if Markazi had an account there.

Citibank, London, of course, has an account in its New York head office. Through the international payments communication system, SWIFT (Society for Worldwide Interbank Financial Transfers), a message is sent to Citibank, New York to remove money from Citibank, London's account and transfer it to Chemical Bank. This transfer is effected through the domestic payments system used for international dollar payments or CHIPS (Clearing House Interbank Payments System), the clearing house system in New York. The payment would be executed on the same day as the instruction is sent from London and the payment issued through the CHIPS system would be paid in so-called clearinghouse funds. The CHIPS system is simply an offsetting mechanism where dozens, indeed hundreds, of banks abroad with accounts

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in New York make payments to one another through other accounts in New York. Every day these totals paid into and out of various banks (and even within banks) are totalled up. At the end of the day the CHIPS people figure out who owes whom what, and the net amount that is owed. The net amount owed between the fourteen settlement banks is then transferred in real money the following day, and the real money is no longer so-called clearinghouse funds but dollar bills or their equivalent, deposits in accounts at the Federal Reserve Bank of New York. Exhibit 4 shows an example of a CHIPS settlement, with Chemical Bank and Citibank making various payments to one another. At the end of day one, the net amount is totalled up and the following day that net amount is paid. If Citibank turns out to owe Chemical Bank a certain amount, it is paid through the "Fed wire", i.e., through transfers between accounts at the New York Federal Reserve or at other Federal Reserve banks.

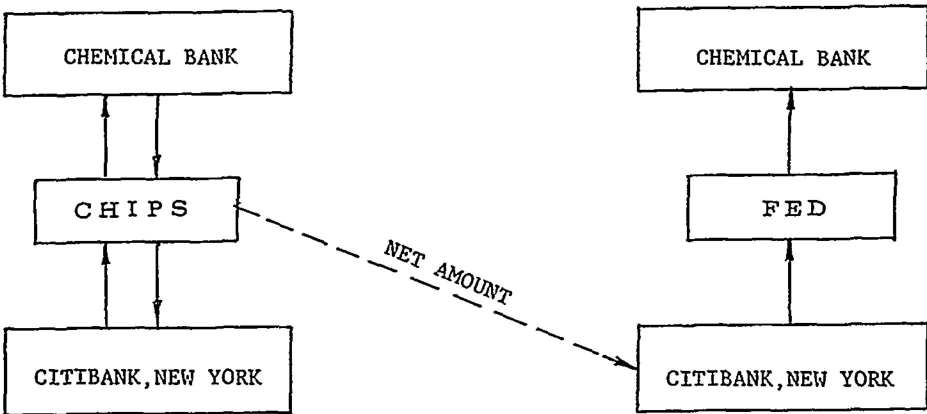

Exhibit 4: TWO U.S. PAYMENT SYSTEMS

That is how it works. It all goes through the U.S. clearing system, CHIPS, and ultimately gets paid in what everybody terms "good money", money that can earn interest because it constitutes scarce reserves at the Fed. Because all this has to go through New York, any payment made between two banks in London, including between Markazi and Citibank, was subject to the freeze the moment it started to pass through the New York clearing system since the freeze applied to transfers not only made by, but also on behalf of, Bank Markazi or any other entity of the national government in Iran. The freeze was not necessarily confined to U.S. banks but the U.S. government chose not to try to impose it on foreign banks as well.

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To conclude, one of the questions that arose out of this case and one of the first thoughts that occurred to Bank Markazi and its lawyers at Stephenson Harwood was, why don't you try to make the payment in some other way? There are several ways in which you can make this payment in London. If Bank Markazi wants to be paid by Citibank, one way is the wheelbarrow method: the dollar bills are wheeled down the Strand in London from Citibank's branch to Markazi's. Unfortunately, the sums involved would have meant such a huge wheelbarrow, such a huge shipment, that the banks were simply going to argue that this was not a normal, accepted means of payment and so they were not obliged to do it.

There are other methods, asserted Markazi. They could have paid in gold or securities, or they could have made the payment in the equivalent amount in some other foreign currency. Citibank and other banks argued, with some merit, that none of these was the normal and expected means of payment. However, of course, the case was never decided in court. So we do not know yet whether the courts would have decided that Citibank was obliged to make that payment.

D. CHIPS

The Iranian freeze called into question the whole system of international financial transfers denominated in dollars. It is a system that has worked extraordinarily well. This system is part of the reason for the fact that fifty-two percent of world trade and seventy-two percent of the Euro-currency market is denominated in U.S. dollars. About ninety-five percent of all foreign exchange transactions in the world goes through the U.S. dollar payments system, even between, for example, the German mark and the Swiss franc. In other words, the CHIPS system has to handle the great bulk of international transactions in the world. On an average day CHIPS handles $160 billion worth of payments, which is confined to international transactions and does not include U.S. transactions. A $160 billion may not sound like very much, but the total world trade that occurred in 1980 was about $1.8 trillion. Therefore, CHIPS could handle in twelve trading days the whole of 1980's world trade --all the oil and goods and so forth that passed among all the countries in the world.

Why does it have to go through CHIPS? First, it is rather efficient if everybody everywhere in the world knows that there is only one payment system, only one location to which they have to make payments when doing transactions with one another. It is like having only one currency for doing different sorts of transactions instead of having to go through many payment systems. But the fundamental reason why everything goes through CHIPS instead of, for example, an alternative clearing system in London such as is being proposed, is that any payment system that involves settlements between banks over time, rather than instantaneously, involves out-payments sometimes preceding in-payments. The CHIPS system is settled on a two day basis. The amount that is transferred between banks in any one day is settled in Fed funds the following day. In the future, same-day settlement will be instituted but the principle remains.

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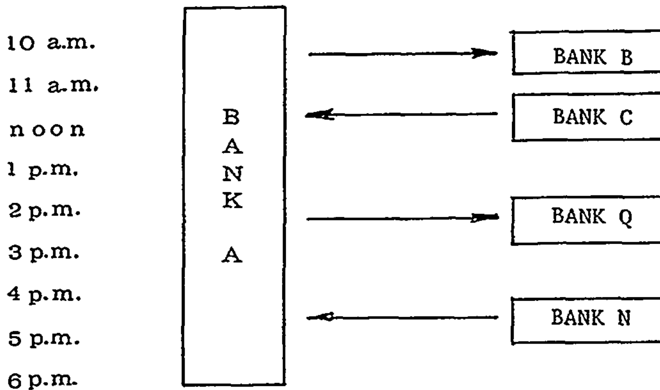

Exhibit 5: CHIPS INTRADAY SETTLEMENT RISK

Exhibit 5 indicates what happens on a typical trading day during which international payments go through the CHIPS system. They are not paid in real money yet. They are only paid in clearing-house funds, which is an understanding that real money will be paid the following day, or (when CHIPS moves to a same-day clearing system) later on the same day. This, however, takes time and Bank A, for example, may have various payments coming in and out during the day. At any one point, Bank A may make an out-payment in expectation that they will receive an offsetting in-payment later on because these two transactions already have been concluded. They are just waiting for the clearing system to take effect.

What would happen if, at any point before these transactions offset one another, somebody interrupts the payment system? Somebody closes down the system, or the computer breaks down, or they were expecting a payment from Bank C which is located in Iran and all of a sudden Bank C does not make the payment, or the central bank of that country closes down the bank, or something else goes wrong. In other words, the offsetting payment does not come in before the end of the clearing day. Then all these payments and settlements would have to be unwound. There would be a great deal of uncertainty as to who owed what to whom at that particular point. There would be concern about who was suspect, and to whom you could make out-payments prior to receiving offsetting in-payments. The whole system would slow down and a liquidity crisis could result. The reason CHIPS works so well is that people have confidence in it. If anything of this nature were to go wrong, there are twelve major U.S. banks that are members and therefore backers, essentially insurers of the CHIPS system; the Federal Reserve is assumed to be standing behind these banks. All these banks have access to the U.S. central bank.

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A similar system could be set up in London for dollar payments between banks but so far there has been an unwillingness on the part of any institution or set of institutions to make the investment and take the risks that would be involved in backing a system to assure all payees that they ultimately would get paid any transfer that was due them. Part of the reason for the reluctance is that it would be a dollar payment system in a sterling country. It would have to be backed up by sterling-based banks and ultimately by the Bank of England. This is largely why the international payment system goes through the U.S. and will continue to do so.

3. EFFECTS OF THE FREEZE

A. Deposits with U.S. Banks Abroad

Despite all the concern that was voiced in 1979 when the Iranian deposit freeze was first imposed, concern about the disruption that would result in the international dollar deposit and payment system, very little in fact occurred. The system has proved extraordinarily resilient. Even the fear that U.S. banks would lose deposits was ill-founded, as Exhibit 6 shows.

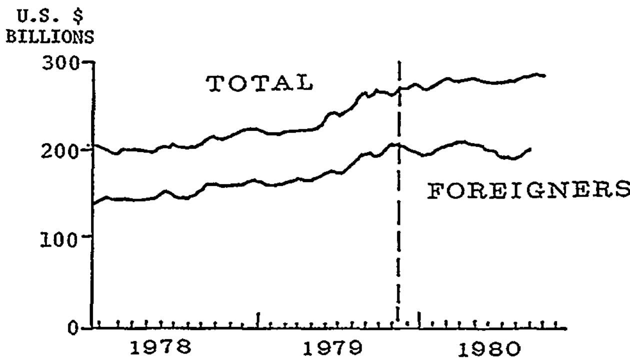

Exhibit 6: EURODOLLAR DEPOSITS IN U.S. BANKS

Source: FEDERAL RESERVE BULLETIN

Based on Federal Reserve data, this diagram indicates the total amount of deposits in U.S. banks abroad denominated in dollars; that total climbed through 1978 and 1979 at a quick pace and continued to climb in 1980. Of that total, the bulk was from nonresidents of the U.S. Those deposits dropped slightly after the freeze (indicated by the dotted line) but rebounded shortly thereafter. There has been no mass outflow of deposits from U.S. banks

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or from the U.S. dollar or Eurodollar market as a whole. The reason is simply that even if you have U.S. dollars in a bank abroad and you are subject to this transfer risk, you can protect yourself in various ways--for example, by having a clause in any deposit contract or an understanding even in unwritten contracts that the depositor has the option of receiving payment in another currency, should the original currency of denomination be frozen. However, this agreement will not be costless because if that were to happen, the banks themselves might be subject to the risk of having to pay out in another currency while the currency in which the deposit was made was frozen. Although one can obtain such protection, as with any other form of risk reduction, it is not going to come free. Banks will surely either protect themselves against the risk by stating their exemption from such obligations or, if they provide the option to pay in another currency, they will pay a lower interest rate or charge for that insurance in some fashion.

B. Application of the Freeze to Cover and Foreign Currency Accounts

MR. MUNDHEIM: Let me ask Bob Carswell to answer one question that flows from that very good explanation of Ian's. Ian's explanation certainly indicates that cover accounts in dollars would also be included in a U.S. government freeze. That is, a Eurodollar deposit in Barclay's Bank would also be caught. Why were those cover accounts specifically excepted by the regulations? Ian's other point was that if the deposit agreement had an alternative payments clause, that clause would likely free the deposit from the risk of being effectively frozen. Again, there was a general license for Iranian deposits in U.S. banks abroad denominated in currency other than dollars. Could you explain why those two situations were not ultimately subjected to the freeze?

MR. CARSWELL: There is some history that may not be publicly recorded, but during World War II the Treasury came up with a cover account theory. The theory was that any dollar transfer, wherever located, ultimately had to be done through what was known then as a cover account in the U.S. It was not really a cover account, but the way the transactions worked was known as the cover account theory. I believe a reference to this may have appeared in one lower court decision.

In subsequent blockings (the Chinese, North Korean, Vietnamese, and the Cuban blockings) the issue came up only peripherally, because there were no significant overseas dollar deposits by any of those countries, at least that anybody knew about, and hence, nobody ever really focused on this problem. From time to time an event did occur where an overseas dollar transaction popped up, and the Office of Foreign Assets Control of the Treasury did occasionally invoke the cover account theory to deal with it. For example, in one instance when the Vietnamese tried to make a dollar transfer, and the dollars had to come back to the U.S., Foreign Assets Control took some action.

In any event, the cover account theory was discussed in the Treasury during all those years but I am not aware of its having been really used. When the Iranian blocking came along, everybody recognized that all of a sudden we had something that was unique. U.S. banks had these huge deposits abroad, and if the freeze was going to mean anything, you had to block them. The question was how far you went with a theory that had very sparse legal background, that is, no court decisions that meant anything--and where there were practical limitations to its enforceability. We just had to make a very quick policy judgment on how far one could press the

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theory. The judgment was not to go for the full cover account theory and block overseas dollar accounts in foreign banks, thereby taking on foreign banks and their regulators in all the jurisdictions where dollar accounts were situated. At least, as far as U.S. banks were involved, we had them here anyway, and it was going to be less likely that they could protest. It was simply a practical judgment.

We decided not to include foreign currency accounts in the overseas branches of U.S. banks for the same practical reason. Again, the U.S. government can get to the U.S. banks because the U.S. banks are sitting here with their head offices. In theory we could have said to Chemical Bank in Paris, "Don't pay out the franc account that you have for the Bank Markazi." They would then have been subject to the excruciating problem of which regulator they should listen to--the French or the U.S. It seemed very clear that we were going to have nationalism problems of a high order if we tried to block the franc deposits. Hence, we decided not to do that either.

MR. NICHOLS: But you did. . . .

MR. CARSWELL: I am sorry. We did include them at first, but then within a week or so we reversed that decision because it was perfectly clear it was going to get us in a lot more trouble than the pressure it might put on the Iranians.

MR. MUNDHEIM: Well, in light of your explanation that there are practical difficulties in applying the freeze theory to what I will loosely characterize as cover accounts and to foreign currency accounts, one is then driven, John, to the question of why foreign depositors would not make all their dollar deposits through the branches of non-U.S. banks, since as a practical matter they would recognize that in the event of a freeze it is unlikely that the government would move to a cover account theory to catch those assets.

MR. HOFFMAN: I would suppose that the foreign depositors would be best qualified to answer that question. The evidence that Ian Giddy has pointed to has demonstrated that this was not the consequence that flowed from the Iranian freeze, although there was some speculation that there might be a movement in that direction. People did not, in fact, take the deposits out of the U.S. foreign branches and take them all across the street to National Westminster or Barclay's. The question is, why didn't they, in light of the fact that there was at least some demonstrable incremental risk attendant on keeping the deposits in a U.S. bank branch, rather than in a foreign bank.

Perhaps I should let Ian Giddy give you the real answers. But I want to begin by speculating a little bit. There is probably a combination of reasons. Certainly an American bank holds most of its earnings in dollars. Its assets are not primarily denominated in yen, for example. When you put money into a bank, you are anxious to get it back and to see your deposit backed up by assets that are predominantly in the currency of your deposit. I think that has to be the prime reason.

Ian Giddy pointed out in his remarks earlier that a U.S. bank has a direct means of access to the Fed that is not available to a foreign bank, and that presumably has some bearing on a decision to

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place deposits in U.S. Banks. By the same token, someone who wanted to maintain franc accounts would prefer a French bank over a German bank.

MR. MUNDHEIM: Alec, as a banker what are your thoughts on the question?

MR. VAGLIANO: As Professor Giddy said, there are four different risks here: the condition of the bank, the central bank backing, the host country's political risk, and the transfer risk. Most people, looking at the present situation from their own point of view, see the Iranian situation as a very special one in which there was an outrageous act by the Iranian government. They do not expect their own government (I am speaking now of the foreign depositors) to put them in that kind of a situation; so it is clearly a risk that is very much discounted at the present time.

Still, it is fair to say that there could be circumstances under which this is seen as a precedent. A political situation could arise where people might remember the Iranian occasion, and the risk would then become more relevant and more immediate, and it could result in a different decision.

MR. CARSWELL: I think I should say that from where we sat in the government, we would agree with that, and we were at great pains to say that all the way through. The Iran blocking was a response to a particularly outrageous event. It was not, at least as far as we were concerned, to be regarded as a precedent. Indeed, in the final settlement we did everything we could (and it worked out successfully) to unwind the extraterritorial effect of the whole thing simultaneously with the release of the hostages. So, there is not even a vestige of the extraterritorial blocking left and, again, that was not an accidental policy course.

C. Alternative Payments Systems

MR. MUNDHEIM: Is this alternative payment procedure that you have mentioned, Ian, a practice which is beginning to gain currency?

MR. GIDDY: There are other reasons besides the transfer risk for establishing an alternative payments mechanism. Indeed, I have heard a number of London bankers complain that they have to go through New York and pay the transatlantic communications cost, and that they would like to have a payment system in London. It seems to me that the fact that there are good economic reasons for people to want the payment system in London or elsewhere and the fact that this has not emerged, despite several proposals and studies looking into this, is evidence that the transfer risk has not provided any great incentive to establish a new system.

There has been absolutely no move towards realistic setting up of such a system, although it is true that some payments are made between banks in London for securities purposes, for retail transactions, and for claims among insurance companies.

Bob, could I take the opportunity to reply to one of the questions sent up from the audience?

MR. MUNDHEIM: Certainly.

MR. GIDDY: There is a question that has been asked of me

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that bears directly on this. The question is, if Bank Markazi asked Citibank, London to transfer its credit balance on Citibank, London's books to the account of Barclay's Bank, might this transfer of credit from one account to another in Citibank, London be accomplished without a transfer through New York? In other words, if two entities both have an account in Citibank, London, could London just offset one against the other and not require any transfer through accounts in banks in New York? That is correct: in principle, offsetting payments could be made in London within the same bank. From the evidence that I have seen in relation to the deposit freeze case, that sort of thing is done very rarely but it is done. So, in principle it seems to me that a transfer within a branch to another account within the branch could be made by Citibank, London on behalf of Markazi.

MR. NICHOLS: I would like to follow up with one additional comment. I think it is right, as Ian points out, that as a practical matter, this is something that can be done. There is a legal issue involved, however, that I think becomes quite significant when you consider the amounts that you are talking about in connection with these central bank accounts.

If you have an American bank branch that has a very large deposit from Customer A and it is very happy to do business with Customer A in that magnitude, it may not be so happy to do business with Customer B in the same kind of magnitude, for all sorts of reasons: one being the future relations with Customer B and whether it is going to be a stable account and all those sorts of things. So I think there is a very serious legal question whether Customer A can direct the bank to establish a similar account for Customer B. I do not think there is anything in the implied contract of deposit between the bank and Customer A requiring the bank to do business with Customer B on a similar basis. Such a requirement would be the consequence of that kind of transfer directed by Customer A, unless, of course, Customer B has an account.

MR. MUNDHEIM: Our discussion here will not decide the issue that the British court would have had to decide. We have heard explanations of what the defense would have been; but since we do not know what the answer of the British court would be, we are left with a question rather than an answer. However, it is an issue that depositors and others who deal with the dollar system have to bear in mind, and I think all we want to do is to recognize that it is an open issue and to understand the basis of the U.S. position and the bank defense.

D. Foreign Currency Accounts

MR. HOFFMAN: I would like to add one other comment that bears on a couple of things that some of the others on the panel have said with regard to foreign currency accounts in U.S. banks. It has been pointed out that almost immediately after the freeze a license was issued which permitted transfers of foreign currency accounts. These were no longer blocked, for reasons Bob Carswell pointed out. One of the consequences of that license was the establishment of a fact that bears on the validity of the legal theory of the freeze defense in London.

The freeze defense, remember, was predicated on the fact that dollars always remain in the U.S. All dollar transfers must be done in the U.S. By the same token, guilders are currency in the Nether-

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lands, not in England or in Japan. If you do a transfer of a guilder account, another Euro-currency, it has to go through the Netherlands. Soon after the freeze had been imposed and the license for these foreign currency transactions had been issued, such a transfer was made by Bank Markazi, which had a guilder account with a European branch of an American bank. Markazi directed the transfer to be made in the bank in the Netherlands, recognizing the fact that such a transfer must go through the Netherlands because that was the local currency of deposit.

MR. MUNDHEIM: Robert, you had a comment.

MR. CARSWELL: Let me just close, or try to close, a circle. I think you ought to remember, in assessing the transfer risk issue, that when the U.N. imposed sanctions on Rhodesia some years ago, in the early 1970s, it included the freezing of accounts in its resolutions. The U.K. at that point adopted its own freeze measures in the U.K. and, in fact, froze Rhodesian pound accounts in the U.K. on a basis parallel to what the U.S. and other countries did. So, your transfer risk is not solely an Iranian experience. It does come up, has come up from time to time, in other jurisdictions. If you start thinking of what other bank you could go to, to be assured of no problems, you may have to recognize that there is no sure escape. I do not suppose anybody can predict where the next tensions will come, and in what currency and with what relationships they will be confronted.

MR. MUNDHEIM: Let me ask one additional question in light of that particular observation. If someone has a dollar deposit with a London branch of a U.S. bank and the British freeze payments, can that depositor come to New York and say, "I deposited some dollars with your bank and now I would like them back."

MR. NICHOLS: No.

MR. MUNDHEIM: Because. . .

MR. HOFFMAN: No--unless it is specifically spelled out, which it may be. I believe in many instances if the deposit is reflected by a certificate of deposit, a CD, the terms may be typed or written right on the document. If not, it is an implied term of the deposit contract that is subject to the laws of the country in which the branch is located. Without taking up a lot of time, I am convinced that such a position is not inconsistent with the elaboration of the argument we made. Although some people may be willing to debate it on another occasion, I think that it is widely recognized that if you maintain a deposit on the books of a branch in London, you are subjecting yourself to regulation and control by the U.K. Mr. Nichols, would you disagree?

MR. NICHOLS: No, I do not think I would disagree. The Fed thinks there is a difference between Eurodollars and domestic dollars, and it treats them differently for a number of regulatory purposes. Obviously the theory is that the Eurodollar market is less attractive to American depositors because there is a different level of risk. In other words, everybody has always assumed, or should have assumed (although I must say I do not think bank deposit contracts are written as clearly on this point as they might be) that if you have U.S. dollars on deposit in Nassau, and the Bahamian government chooses to impose a system that says, "You can get paid

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the dollars in Nassau but you cannot get them out" you will be unable to recover against the head office in the U.S. I have always assumed that everybody understood that this kind of a freeze was a possibility. Now, the Bahamians are presumably cutting their own throats in the process, so nobody thinks it is very likely. But there have been times, I believe, when dollar deposits in the Bahamas have commanded rates different from those on dollar deposits in London, because it is assumed that there is a different risk as between the Bahamas and the U.K.

MR. VAGLIANO: That is right. I think that in the early period of the Eurodollar market, for example, there were some of the more conservative Swiss depositors that hesitated about putting their Euro-deposits in London because of the British risk.

MR. MUNDHEIM: Fred, you had a comment?

MR. HELDRING: I have no comment on the legality, but one on the matter of practice. We have a branch in Nassau and were one of the first to have one. We have always thought that if something happened, we would just transfer our books back to the U.S. and pay. It is a branch and we pay.

MR. NICHOLS: One New York bank is defending pretty vigorously a suit for dollar deposits made in its Saigon office, if I am not mistaken. You also have the fact that if you tell your customer that you are prepared to pay him in Philadelphia, you are going to have to keep reserves against the deposit.

There is a very specific Fed interpretation of Regulation D, which says that if an American bank guarantees repayment at its head office of a foreign office deposit, then that becomes a U.S. deposit for Regulation D reserve purposes--and I would assume probably also for Regulation Q purposes if there were a Q ceiling applicable.

NOTES

[1] Exec. Order No. 12170, 44 Fed. Reg. 65729 (1979).

[2] White House Press Release, 15 Weekly Comp. of Pres. Doc. 2117 (Nov. 14, 1979).

[3] *See* 31 C.F.R. pts. 500, 515 (1980).

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Lessons from the Iranian Experience:

IMPACT ON LOAN SYNDICATIONS AND OTHER INTERNATIONAL TRANSACTIONS

Bruce W. Nichols

MR. MUNDHEIM: I think we have illuminated a number of issues relating to deposits. It is time to turn to the lessons learned from the experience of banks as lenders. Bruce, could you begin our tour of that problem?

MR. NICHOLS: Let me first say that I think the deposit issues are really the more interesting issues, and I am going to come back to them. You do not want to listen to lawyers spout statistics, but in view of all the comments that have been made to the effect that the Eurodollar market is alive and well and living in your telex machine, I thought perhaps you should have at least a few statistics that may point in the other direction.

The Bank for International Settlements collects figures from large banks in a number of jurisdictions. Those figures show that between the end of 1979 and the end of the third quarter of 1980, the liabilities of the U.S. bank segment of the reporting universe to the oil exporting countries did not decline in absolute terms, but in percentage terms they fell from thirty-seven percent to twenty-nine percent. In other words, the liabilities of the non-U.S. banks to the oil exporting countries grew absolutely and grew relative to the liabilities to those countries of banks in the U.S. The figures for Eastern Europe are even more interesting. The U.S. banks' proportion of those liabilities fell from 10.4 percent to 5.8 percent, and the absolute amount of liabilities of the U.S. reporting banks to the Eastern European countries also fell. So it seems--and there are other statistics that point in the same direction--that the oil exporters, who are the big accumulators, are diversifying their currencies. That process almost certainly began before Iran, but I do not think one can totally ignore Iran as a factor fueling the move to further diversification.

I noticed in Mr. Cooke's paper that there are a couple of references to Herstatt and no mention of Iran. In many ways, perhaps Herstatt was a more important influence on the Euro-markets than Iran. On the other hand, I think it would be a mistake to say that the markets have not been influenced by Iran, and I shall come back to that point when we get to the deposit side. Rather, I think that we have not seen the Iranian story play itself out completely.

1. IMPORTANCE OF LOAN DOCUMENTATION

Switching now to the loan side, one of the things we argue about at conferences like this is whether the loan documentation makes any great difference. There are Continental lawyers who say that the twenty-five and thirty page loan agreements drafted by English and American lawyers are so much verbiage and that in the

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end the foreign government is either going to pay you or it is not. So what difference does it make what you say in your documentation? I suppose at the height of the crisis when we were all reading the agreements furiously and when we were having lawyers around the world give opinions as to what they meant and were preparing to carry questions of interpretation to the supreme courts of three or four different countries, we all more or less said, "Well, this proves that loan documentation is important."

One of the arguments given by those who say that documentation is not important is that when a foreign country reaches the stage of not paying its debts, it probably has no foreign assets. I suppose the great lesson of Iran was that a country with vast foreign assets might nevertheless decline to pay its debts. Thus a fair amount of asset-grabbing went on; that is to say, the American banks set off, or thought they had set off, Iran's deposits against Iran's debts. Certain Iranian assets in Germany, and in this country also, were attached by creditors of Iran. As you have already heard, Iran has brought lawsuits in both the English and the French courts to recover its deposits. Certainly we were all getting prepared, if this thing had gone on for any great length of time, to deal in minute detail with various kinds of loan documentation problems. I think I could show you a stack of legal opinions and professorial advice--and I am sure John could show you an equally high stack--interpreting any number of clauses in these documents.

In the end, we have to recognize that what happened was a political settlement; and as far as the syndicated loans were concerned, it was a global settlement. The fellow with the three page loan agreement got his money back, just as the fellow with the thirty-three page loan agreement got his money back. When one is having an argument with Continental lawyers as to whether the extensive documentation is or is not really important, I am not sure that we can point to Iran as proof positive that it is--although I still believe so.

2. AREAS OF REEXAMINATION

Now it is true that the Iranian experience has had some impact on what is being put into these documents, or at least what people are asking to have put into these documents. This is a highly professional audience. Some of you spend more of your time in this area than I do, and therefore I am going to hit some high spots rather than try to go into extensive detail. I have appended at the end of the chapter a few excerpts from specific documents for those of you who appreciate detail.

A. Central Bank Guarantees

The fact that a borrower with external assets can refuse to pay its debts is going to lead to some greater attention in sovereign lending as to whether the fellow you are lending to is the fellow who has the external assets. If Bank Markazi had guaranteed all of the Iranian public sector's external debt, I think we all would have felt that our setoffs were a good deal more solid than they were. In other words, the basic issue on the setoffs was that the deposits were basically those of Bank Markazi, and the debts were those of the government of Iran or the National Iranian Petrochemical Company or some other entity within the Iranian public sector. I suppose that if the lenders were in the driver's seat (which

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they are not and have not been for a very long time) you would see renewed attention to the question of central bank guarantees, because external assets tend to be held in the central bank's name and the foreign liabilities tend to be issued in the names of other parts of the government. I take it that there is no banker in the room who would say that he would not love to have a central bank guarantee of all his governmental lending, but it is not easy to obtain.

I could take one Latin American country, which has occasionally given central bank guarantees, and draw a graph to show you that such guarantees are given when the credit of the country is at its lowest ebb and that they disappear the minute the country's credit standing rises. As a practical matter, I doubt that there will be a notable increase in the number of central bank guarantees that bankers can obtain.

B. Jurisdictional Clauses

Another matter which was of particular importance to those of us who got involved in Germany is the jurisdiction clause. The jurisdiction clause in one of the important Iranian loan agreements reads as follows:

> Any legal action or proceedings with respect to this Agreement by the Borrower against the Agent and/or the Banks may be brought at the option of the Borrower in any court of competent jurisdiction in Iran or elsewhere and against the Borrower may be brought at the option of any Bank or the Agent in courts of competent jurisdiction in England or Iran or in New York....

If the German litigation had gone to a conclusion, one of the most important issues--probably *the* most important issue--would have been whether the jurisdiction clause saying that the banks could sue Iran in the courts of England, New York or Iran was permissive--in the sense that you could sue there and that you could sue any place else you felt like, too--or whether it was exclusive and meant that you could sue only in those jurisdictions, and hence not in Germany.

I continue to feel (wearing my lender hat) that it is very important to make clear that your jurisdictional submissions are not exclusive. If you hypothesize a situation in which a borrower has external assets and still does not pay his debts, you cannot know what jurisdiction those external assets are apt to be in. If you lock yourself into suing in one court or two courts when the external assets are in fact in the third country, your client may well get annoyed at you if your case fails on that ground. Moreover, this is something about which the average borrower, at least in my experience, has not been too resistant--at least up until now.

C. Event of Default

Another interesting aspect of Iran was the argument that the Iranians were getting all set to make the payments, and that it could not have been an event of default because they were prevented by law from paying. The Iranians have asserted that they had every intention of paying. Indeed, for the Government loan, the payment instructions were already here in New York when the freeze occurred. The Iranians asserted that banks could not call a default and accelerate a loan if the non-payment is not the borrower's fault but rather the result of force majeure. I think English law and New

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York law probably would not accept that as a correct view of the contracts as they have been written. It is possible to make it very, very clear in your acceleration clause that you have tried to preserve your acceleration right notwithstanding the fact that the failure to pay or the other event of default results from force majeure, and not from a voluntary act on the part of the borrower. One such clause, not the most artfully drafted one I have ever seen, reads as follows:

> then, and in any such event (an "Event of Default"), whatever the reason for such event and whether or not it shall be voluntary or involuntary or be effected by operation of law or pursuant to any judgment, decree, order, law, rule or regulation of any governmental agency, the Agent may, and shall upon request of the Majority Banks . . .

I do not know whether the borrowers are going to resist such a clause strenuously, and I am not even sure as a legal matter that I want to put it in, because I think it may raise some questions. Traditionally such a clause has tended to appear in insurance company private placement agreements and has not tended to appear in domestic bank loan agreements. But it certainly is an issue worth thinking about.

D. Remedy Clauses

All of us who write loan agreements with foreign sovereigns have for a long time been trying to focus on what I would call the remedy clauses, but the fact that the Iranian litigations all began with pre-judgment attachments tends to show the importance of such attachments. The people who write these clauses are going to focus even harder than they have in the past on spelling out the kinds of remedies against the foreign sovereign borrower they think they ought to have.

Pre-judgment attachment is obviously terribly important in a situation where you have a borrower who has external assets but who has a political reason for not paying. Obviously, if you sue him in Jurisdiction A where he has assets and you cannot get a pre-judgment attachment or *Mareva* injunction, by the time you get judgment in Jurisdiction A, those assets are going to be in Jurisdiction B, C, D, E, or F. Thus pre-judgment attachment and a specific consent to pre-judgment attachment is, I think, a matter of renewed concern on the part of lenders.

E. Control of Acceleration Rights

Another aspect of Iran is that the non-American banks in the syndicates got pretty annoyed with the American banks in the syndicates. With respect to those Iranian loans that were in fact accelerated, the acceleration was done over the strenuous objection of the non-American banks in the syndicates. Thus one heard announcements by some foreign banks that they would never again join a syndicate in which the American banks had the percentage necessary to accelerate. There are not many foreign banks following that kind of rule, but there is no doubt that those percentages--which tended not to be thought about very seriously--are now being looked at very much harder.

For some reason, Euro-agreements have tended to have the same percentage for covenant waivers as they have had for acceleration. I think the usual formula would be that the Majority Banks (defined

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usually as 66.66 percent by amount) can waive covenants, and the same percentage can accelerate. Those two percentages do not necessarily have to be the same, although they do have to overlap. It would be utterly inconsistent to say that thirty percent could accelerate and 66.66 percent could waive the covenant, because you then have a Mexican standoff. There would be nothing inconsistent, however, in saying that 66.66 percent could waive covenants but that only forty percent was required to accelerate. I think acceleration provisions are getting a much harder look, and they should. I have no doubt that some foreign banks are a little nervous about joining syndicates where it is clear that the American banks in the group, acting alone, would be able to cause an acceleration.

F. Sharing Provisions

Another matter now receiving extensive attention is the so-called sharing provisions, which are common in Euro-loan agreements. These came into the Euro-market from American domestic lending practice, where groups of American banks were lenders and were fearful of the fact that the borrowing company might have all its deposits at one or two of the big banks. The smaller banks would argue that if a setoff had to be made, surely there ought to be a sharing of setoffs.

Thus the sharing clauses are often called setoff sharing clauses, although that may not be strictly accurate. Some of them are setoff sharing clauses; some share almost any conceivable method of repayment. In other words, some clauses say that if you get repaid by any means disproportionately to the amounts the other banks are paid, then you have to share. Some of them say that if you get paid voluntarily by the borrower or through the exercise of setoff, then you share, but that if you sue the borrower you do not have to share. All those clauses are coming under intense review. Comments come back from groups of lenders on those clauses to a much greater extent than used to be the case.

G. Agents' Authority

Also relating to the rights of the bank group members among themselves, the extent of the agent's discretionary rights and authorities has been called into question by Iran. A lot of the Iranian agreements that had named American banks as agents said that the agent could, acting on its own, accelerate if it wished to do so and that it must accelerate if requested to do so by a specified percentage of the banks. As far as I know, no American agent exercised the discretionary part of that authority.

I think a number of foreign banks were made nervous by the existence of the discretionary power to accelerate. On the other hand, suppose that one of the plaintiff banks in Germany had been thrown out of court when it sued on a loan that had not in fact been accelerated, and let us assume hypothetically that the same bank had won and actually recovered on another loan that had been accelerated. Would that bank have had a cause of action against the agent that had failed to accelerate although it clearly had the right to do so? You may find an even greater effort on the part of the syndicate banks to curb any discretionary authority in the agent--perhaps particularly when it is an American agent.

Also, and as a result of Iran, you find a much greater tendency to write clauses making it absolutely clear that the specified

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majority of the banks may instruct the agent how to proceed on any matters where the agent is supposed to proceed. You also find much greater attention to clauses saying that the banks in the group can fire the agent if they want to fire him.

The latest wrinkle I have run into is requests from non-American banks to put in clauses that specifically permit the payments to be routed around the agent if the agent has trouble handling the payments. One such clause reads as follows:

Notwithstanding anything to the contrary contained in this Agreement or in any Note, if it shall become unlawful or, in the opinion of the Agent, impracticable for any payment to be made as aforesaid and the Agent shall give notice to the other parties hereto to that effect, then the Borrower shall pay to each Lender for its own account in such funds as are required by Section 3.2 or in such other manner as may be agreed between the Borrower and the relevant Lender and to such account as may be specified by the relevant Lender to the Borrower the amount of the relevant Lender's participation in the payment in question. Each Lender shall keep the Agent fully informed as to all amounts received by it and as to all agreements made between it and the Borrower as referred to above.

3. DEPOSIT DOCUMENTATION

Obviously, a lot of things I have discussed are things that lenders ought to be asking borrowers for. Conversely, borrowers, having seen the fact that the American banks were pretty aggressive, will be reacting opposite to the way the American bank lawyers have been reacting. It is curious that what little fallout Iran has had, has been in the area of loan documentation because, as John and Ian have said, the right place for the fallout is the field of deposit documentation. And yet, as far as I know, there has not been any great pressure on deposit documentation.

In the 1950s, as far as I can tell, New York banks did take foreign currency deposits here in New York. In a letter written by a New York bank to an inland correspondent bank that had deposited the magnificent sum of four hundred pounds with the New York bank, I found a clause that says--in absolutely clear language--that the New York bank was going to put the four hundred pounds on deposit with its London office and that the inland bank was going to take the risk that that money could not be gotten out of London. In other words, the paragraph says that the inland bank is to be in exactly the same position vis-a-vis English law and regulations as it would have been in if it had taken the money to London and deposited it there.

The German banks in their standard business terms and conditions say roughly the same thing. The official English translation of the standard business terms and conditions applied by the German private banks says:

The holders of credit balances in foreign currency maintained at the bank shall share in proportion to and up to the amount of their balances all financial or legal disadvantages and damages which might affect the bank's balances in the respective currency in consequence of force majeure, war, riots or similar events or in consequence of acts of third parties abroad not caused by the bank's fault or in connection with acts of domestic or foreign authorities.

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Thus, if you deposit a thousand dollars with the Deutsche Bank in Frankfurt and Bob Mundheim deposits a thousand dollars with the Deutsche Bank in Frankfurt, and something goes wrong, and the Deutsche Bank is able to get only a thousand dollars back from the U.S., then Bob will get five hundred dollars and you will get five hundred dollars. I believe, although I am not certain, that a number of Swiss banks use a standard business condition similar to that used by the German banks.

This shows that for a long time bankers have understood the problem of the dual risk inherent in a deposit in one country in the currency of another country. Yet in the Eurodollar time-deposit market, where the contract is normally entered into by a pretty simple exchange of telexes, they have chosen to leave the matter fuzzy. Now that Iran has happened and the international banking community knows what the problems are, I wonder whether the risk of ambiguity is shifting. I wonder whether the depositors ought to come, as Ian Giddy suggests, and ask for a dual currency contract. As far as I know they have not done so. I also wonder whether the banks that leave the issue ambiguous may possibly be in for trouble. I think we are going to hear more on that issue.

As far as I can tell, the Eurodollar bond market has not made changes in its documentation as a result of Iran. The standard bond language makes it perfectly clear that the bond is payable in New York in dollars and that it is a matter of the issuer's grace and favor as to whether it has any paying agencies outside the U.S. If the issuer does pay outside the U.S., it does so only by a transfer payable inside the U.S.

4. POLITICAL RISK

A look at the history of World War II may help explain why the depositors have not been rushing to put their money with third country banks. The fact of the matter is that both we and the British at the beginning of the war--and indeed we even before we got in the war--froze the assets of all the neutral countries of Europe. Swiss deposits in the U.S. were frozen in just the same way that German assets were, and an elaborate system was worked out by which the Swiss could certify that the owners of those assets were in fact Swiss.

There is no complete escape from the political risk in holding assets outside your own country. It all depends on how determined and fanatic Mr. Carswell and his henchmen in the Treasury want to get. He explained to you that he probably could have frozen the Iranians' dollar deposits at the Union Bank of Switzerland. He was sensible not to try; but I suppose that if we had gotten into some kind of a hot war with Iran, he might have tried. Thus, I think that the reason for the apparent lack of pressure from depositor countries is a recognition that Iran was a unique event and is not apt to repeat itself plus a realization that, in the end, if the U.S. wants to tie up its dollars it can probably do so.

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APPENDIX VII

EXCERPTS FROM SPECIFIC DOCUMENTS

ITEM 1: Portion of the jurisdiction clause from an actual Iranian loan agreement:

(a) Any legal action or proceedings with respect to this Agreement by the Borrower against the Agent and/or the Banks may be brought at the option of the Borrower in any court of competent jurisdiction in Iran or elsewhere and against the Borrower may be brought at the option of any Bank or the Agent in courts of competent jurisdiction in England or Iran or in New York....

ITEM 2: Portions of the jurisdiction clause in a recent international loan agreement:

10.2. *Consent to Jurisdiction.* The Borrower irrevocably submits to the jurisdiction of any New York State or Federal court sitting in the City of New York over any suit, action or proceeding arising out of or relating to this Agreement or any Note.

* * * * *

10.5. *No Limitation on Service or Suit.* Nothing in this Section 10 shall affect the right of the Agent or any Bank to serve process in any manner permitted by law or limit the right of the Agent or any Bank to bring proceedings against the Borrower in the courts of any jurisdiction or jurisdictions.

ITEM 3: Portions of the default clause in a typical international loan agreement:

If any one or more of the following events ("Events of Default") shall occur and be continuing:

(a) failure by the Borrower to make any payment of the principal of and interest on the Notes when due and payable. . .

then the Agent may, and shall upon the written request of the Majority Banks, by notice of default given to the Borrower, declare all the Notes outstanding hereunder to be forthwith due and payable. . .

ITEM 4: Portion of the default clause in a recent international loan agreement:

then, and in any such event (an "Event of Default"), whatever the reason for such event and whether or not it shall be voluntary or involuntary or be effected by operation of law or pursuant to any judgment, decree, order, law, rule or regulation of any governmental agency, the Agent may, and shall upon request of the Majority Banks. . .

ITEM 5: Remedies clause in an actual Iranian loan agreement:

(b) To the extent that the Borrower may be entitled to claim for itself or its assets immunity from suit or other legal process, the Borrower hereby irrevocably agrees not to claim

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and hereby irrevocably waives such immunity to the full extent permitted by Iranian law.

ITEM 6: Remedies clause in a more detailed international loan agreement:

6.1 *Waiver of Sovereign Immunity.* To the extent that the Borrower or any central bank or monetary authority of the Borrower may be entitled, in any jurisdiction in which judicial proceedings may at any time be commenced with respect to this Agreement or the Notes, to claim for itself or its revenues, assets or properties sovereign immunity from suit, from the jurisdiction of any court (including but not limited to any court of the United States of America or the State of New York), from attachment prior to judgment, from attachment in aid of execution of a judgment or from execution of a judgment and to the extent that in any such jurisdiction there may be attributed such a sovereign immunity (whether or not claimed), the Borrower, for itself and for its central bank or monetary authority, hereby irrevocably agrees not to claim and hereby irrevocably waives such sovereign immunity in respect of suit, jurisdiction of any court, attachment prior to judgment, attachment in aid of execution of a judgment and execution of a judgment.

ITEM 7: Sharing clause in an actual Iranian loan agreement:

If the Borrower pays any amount payable by it hereunder directly to a Bank otherwise than in accordance with Clause 10(a) above and as a result such Bank receives a greater payment than it would have been entitled to have received under Clause 10(d) above such Bank shall promptly remit such payment to the Agent which shall promptly distribute the same in compliance with Clause 10(d) above.

ITEM 8: A somewhat broader sharing clause in another international loan agreement:

10.9 *Sharing of Set-Offs and Other Payments.* Each Bank agrees that if it shall, whether through the exercise of a right of banker's lien, set-off or counterclaim against the Borrower or otherwise, obtain payment of the indebtedness (for principal or interest) to it by the Borrower hereunder which is proportionately greater than the payment of such indebtedness obtained by any other Bank, (i) it shall be deemed to have simultaneously purchased from such other Bank an interest in such indebtedness held by such other Bank so that the aggregate unpaid amount of such indebtedness and interest thereon held by each Bank shall be proportionate to the aggregate indebtedness owing to it by the Borrower hereunder immediately prior to such payment and (ii) such other adjustment shall be made from time to time as shall be equitable to ensure that each Bank shares in such payment pro rata; provided, however, that if all or any portion of such proportionately greater payment of the indebtedness is thereafter recovered from such purchasing Bank, the purchase shall be rescinded and the purchase price restored to the extent of such recovery, but without interest.

ITEM 9: Selected sections relating to the agent in a post-Iran agreement:

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8.2 *Majority Lenders.* The Agent shall, to the extent practicable under the circumstances, consult with all of the Lenders prior to taking action on their behalf under this agreement, or under any other agreements or instruments contemplated hereby. The Agent shall not take any action contrary to the written direction of the Majority Lenders and shall take any lawful action in accordance with the provisions of this Agreement prescribed in a written direction of the Majority Lenders.

The Agent may decline to take any action except upon the written direction of the Majority Lenders and the Agent may obtain a ratification by the Majority Lenders of any action taken by it under this Agreement. In each case the Agent shall have no liability to the Borrower, the Managers or any of the Lenders for any action taken by it upon the direction of the Majority Lenders or that is ratified by the Majority Lenders, nor shall the Agent have any liability for any failure to act (except as contemplated by Section 8.7) unless the Agent has been instructed to act by the Majority Lenders, the action of the Majority Lenders in each case being binding on all the Lenders hereunder. Notwithstanding anything herein to the contrary, the Agent need not take any action on behalf of the Lenders unless and until it is indemnified to its satisfaction for any and all consequences of such action.

* * * * *

8.8 *Successor Agent.* Subject to the appointment and acceptance of a successor agent as provided below, the Agent may resign at any time by giving prior written notice thereof to each Lender and the Borrower, and the Agent may be removed at any time with or without cause by the Majority Lenders. Upon any such resignation or removal, the Majority Lenders shall, with the approval of the Borrower, have the right to appoint a successor agent. If no successor agent shall have been so appointed by the Majority Lenders and shall have accepted such appointment within 30 days after the retiring Agent's giving of notice of resignation or the Majority Lenders' removal of the retiring Agent, then the retiring Agent may, on behalf of the Lenders, appoint a successor agent, which shall be a commercial bank (or a financial institution with an affiliate that is a commercial bank) with a banking office in New York, New York. Upon the acceptance of any appointment as Agent hereunder by a successor agent, such successor agent shall thereupon succeed to and become vested with all the rights, powers, privileges and duties of the retiring Agent, and the retiring Agent shall be discharged from its duties and obligations hereunder. After any retiring Agent's resignation or removal hereunder as Agent, the provisions of this Section 8.8 shall continue in effect for its benefit in respect of any actions taken or omitted to be taken by it while it was acting as the Agent hereunder or under any document contemplated hereby.

ITEM 10: A provision in a post-Iran agreement permitting payments to be routed around the Agent:

(b) Notwithstanding anything to the contrary contained in this Agreement or in any Note, if it shall become unlawful or, in the opinion of the Agent, impracticable for any payment to be made as aforesaid and the Agent shall give notice to the other parties hereto to that effect, then the Borrower shall pay to each Lender for its own account in such funds as are required by Section 3.2

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or in such other manner as may be agreed between the Borrower and the relevant Lender and to such account as may be specified by the relevant Lender to the Borrower the amount of the relevant Lender's participation in the payment in question. Each Lender shall keep the Agent fully informed as to all amounts received by it and as to all agreements made between it and the Borrower as referred to above.

ITEM 11: Excerpt from a letter sent by a New York bank in the 1950s to a customer who had deposited sterling with such bank's New York head office:

> As a matter of record, we wish to advise you that this sum of £400, together with other funds of customers, is carried in an account in our name with our London Office, upon and subject to the conditions, however, that such funds shall stand with our London Office for your account and risk, in the same manner and with the same effect as if they had been deposited by you directly with an English bank, and shall be governed as to payment and in other respects by the statutes, decrees, regulations, ordinances, etc. of the authorities de facto or de jure controlling England. Please note further that these funds are not payable here in actual currency but are available only by check or cable transfer in England through us as your Agent to transmit instructions subject to the conditions above stated.

ITEM 12: Official translation of Clause 3(2) of the General Business Conditions applied by all privately owned German commercial banks:

> The holders of credit balances in foreign currency maintained at the bank shall share in proportion to and up to the amount of, their balances all financial or legal disadvantages and damages which might affect the bank's balances in the respective currency in consequence of force majeure, war, riots or similar events or in consequence of acts of third parties abroad not caused by the bank's fault or in connection with acts of domestic or foreign authorities.

ITEM 13: The payment language contained in a U.S. dollar certificate of deposit currently issued by the London office of an American bank:

Negotiable Certificate of Deposit

CONSOLIDATED BANK OF NEW YORK, 5 OLD BROAD STREET
LONDON E.C.2

No. .... London............

THIS CERTIFIES that there has been deposited with Consolidated Bank of New York, London Office the sum of .... U.S. $........ payable to bearer/order of..........upon the .....fixed ("the date of maturity") with interest (for the actual number of days on a 360 day year basis from the date hereof to the date of maturity only) at the rate of ....

Payment will be made solely at the above mentioned London Office upon surrender of this Certificate and will be made by draft on or telegraphic transfer addressed to Consolidated Bank of New York, 297 Park Avenue, New York, U.S.A.

This Certificate of Deposit must be presented for payment through the medium of a banker. The rights and obligations herein

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shall be determined by English Law.

....
Authorized Signature

ITEM 14: The alternative payment language in a recent U.S. dollar denominated note publicly offered outside the United States by a finance subsidiary of a U.S. corporation, which appears after a provision making the Note payable at the head office of a New York bank:

At the holder's option and subject to applicable laws and regulations payment of the principal of, premium (if any), Interest and Additional Interest (if any) on this Note will also be made at such paying agencies outside the United States as the Company shall appoint from time to time and at which, at the option of the holder, such payment will be made by check drawn on, or by transfer to a United States dollar account maintained by the holder with, a bank in New York City.

ITEM 15: Excerpts from Reeves, *The Control of Foreign Funds by the United States Treasury,* 11 Law & Contemp. Prob. 17 (1945) (footnotes omitted):

In the face of growing world danger the United States took the next step for its protection on June 14, 1941. On this date an amendment to the Freezing Order was published which added to the list of nations already frozen all the rest of continental Europe: the aggressor, the conquered, and the neutral nations. The preamble to this Order carried the additional phrase not used in the previous Orders: "necessary in the interest of national defense and security." A few weeks later, July 26, 1941, when Japan overran Indo-China, Japan and China were added to this list. China was included at the request of its own government for its assistance and to prevent Japan from using the occupied areas in China as a base for evading the freezing control.

* * * * * *

The considerations of immobilization for preservation of property obviously do not apply to the property of the blocked neutrals. Here the problem is to prevent transactions which might be of advantage to the aggressor nations and in this respect the work of the Control is more in the nature of control of transactions than a blocking of property. At least one problem, however, arises in connection with neutral property not present in respect to enemy property and of much less significance in connection with the property of enemy occupied countries since they are treated under the policy of immobilization. That is, the common practice of European financial institutions to hold within the United States in their own names, funds and securities deposited with them by their clients--persons whose identity, nationality, whereabouts, and very existence cannot be determined until the end of the war. The beneficial ownership in such accounts may be neutral, enemy, or national of friendly occupied countries. Unless the evidence of beneficial ownership is clear beyond a doubt, trading in such accounts might be in derogation of all of the basic policies of the Control. Accordingly, the Treasury prohibited all transactions, including the receipt of dividends or interest, with respect to securities held in any account in the name of a financial institution

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located in a blocked country unless the custodian in the United States was furnished with adequate information as to the ownership of the securities, or they were placed in an account from which they could be withdrawn only under special licence.

* * * * * *

The neutral European countries, Sweden, Switzerland, Spain and Portugal, were also granted general licenses for the transactions of their governments and their nationals. Subject to the conditions of the licenses, a transaction could be consummated under official certification or through the central bank for the benefit of a national of the country to which the license was granted. These licenses were granted after the governments of the countries involved gave adequate guarantees and assurances to the United States that the terms and conditions of the general licenses would be strictly adhered to. The basic condition imposed was the obvious one; that under the license no transactions by, on behalf of, or pursuant to the direction of any blocked country or blocked national (other than the country to which the general license was granted or national thereof), could be consummated.

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FOREIGN COMPANIES RAISING CAPITAL IN THE UNITED STATES

Michael H. Coles

1. INTERNATIONAL SECURITIES MARKETS

MR. HAWES: We have been talking about banking. In the fashion of Americans, we separate banking from securities; this is unlike the fashion in Europe where there are universal banks. We will first examine the raising of capital in the U.S. by companies from abroad and then we will discuss the raising of capital abroad by U.S. companies. Thus, we hope to get a clearer picture of the internationalization of the securities markets, particularly the primary markets. Turning next to an analysis of the law on investment by foreigners, we will use as illustrations the law of Japan, the law of Europe (if one may call it that), and the law of the U.S. We will be looking to see whether perhaps there is a need for greater coordination or harmonization of the law on foreign investments in the major countries.

Harmonization is already taking place, to a greater or lesser degree, in accounting and in disclosure rules. We will be examining those subjects as a possible precedent for harmonization and cooperation in other areas. We then take a look at the extent to which the natural forces in the market, especially the trading markets, have pressed beyond national borders without a concomitant extension of regulatory supervision. We will be looking at the barriers to international activity by brokers and, to some extent banks, which have been raised by national interests. First Michael Coles will speak on foreign companies raising capital in the U.S.

MR. COLES: I have been asked to talk about the use of the U.S. capital markets by foreign issuers. Much of the market that I will duscuss is often referred to as the Yankee bond market. This is customarily defined as the U.S. domestic market for debt obligations, either non-convertible or convertible into equity, of non-U.S. issuers, which obligations have been registered with the SEC under the Securities Act of 1933. The Yankee bond market does not generally include debt issued here by Canadian issuers, and I will adhere to this convention. However, in addressing myself to the Yankee bond market, I do not wish in any way to neglect the small but growing market here for pure foreign equity issues.

2. HISTORICAL PERSPECTIVE

A. Development of the Yankee Bond Market

The Yankee bond market is often erroneously considered to be a recent phenomenon. However, if we go back into history we will find that, contrary to its position prior to World War I when the

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U.S. was a substantial debtor country and its growth was financed in large part by European capital, the U.S. found itself in the 1920s as the world's largest creditor nation, being owed significant amounts of money by most of the combatants involved in World War I. As a result, the U.S. became, and with some exceptions and in different degree has continued to be, an important supplier of capital to the rest of the world.

Much of the debt offered in this market during the 1920s and early 1930s lapsed into default during World War II; and much of it still remains subject to settlement plans whereby investors will receive only a small proportion of their original outlay. Most holders, for example, would probably prefer to forget the 1922 Bolivia Eight Percents, due 1947, or the Republic of Cuba four and one-half percent bonds due 1977, issued in 1937. The First Bohemian Glassworks located in Czechoslovakia must have been considered a good investment in 1927 when it issued its seven percent bonds due 1957. Purchasers of the City of Warsaw seven percent bonds issued in 1928 and due 30 years later could hardly have foreseen the destruction of that city in the early days of World War II, and the subsequent subjugation of Poland by the Soviets.

Most of the early Yankee bonds I have mentioned, and many others, are traded at nominal prices on the various stock exchanges. Probably they have greater value in the eyes of investors as the bases of lampshades or colorful bathroom wallpaper. One of the major points I wish to make today is to stress the significant differences between the market for foreign bonds in the U.S. now, compared to the market that existed prior to World War II. Later I will discuss what I perceive to be the much greater safety offered investors in today's Yankee bonds as opposed to their unfortunate predecessors.

Obviously, during most of the Depression and during World War II there was very little activity for foreign bond issuers in the New York market. However, the U.S. came out of World War II as a major creditor nation again, and during the period from 1945 until 1963 the Yankee bond market was the most important non-bank source of U.S. dollar borrowings for foreign issuers. Sales of foreign bonds to U.S. residents reached close to $1 billion in 1962 and during 1963 were running at a rate almost double that amount.

As a result of rising concern about the increasing outflow of capital, the Kennedy Administration introduced in 1963 an interest equalization tax, designed to make it unattractive for most issuers to use the Yankee bond market. In addition, so-called voluntary guidelines severely limited the portfolio investments of U.S. non-bank financial institutions in the securities of foreign issuers.

In 1974 the controls on U.S. investments abroad were removed. Since that time eighty-six straight debt issues aggregating $10.3 billion for twenty-nine non-U.S. borrowers, eight convertible bond issues totalling $475 million for six non-U.S. corporations, and fourteen equity issues totalling $565 million for eleven non-U.S. issuers have been successfully offered in this market.

The theme of this conference is the internationalization of the capital markets. The Yankee bond market now represents a quite significant portion of a global capital market which, over the last ten years, has demonstrated a considerable ability not only to finance the growing and continuing capital needs of the industrialized world but also to take care of the tremendous burden of capital flows resulting from OPEC surpluses and the corresponding deficits on the part of oil importing countries.

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B. The Current Yankee Bond Market

Let us take a look at the Yankee bond market: first, the market for straight or non-convertible bonds. In 1974, after the interest equalization tax was removed, the market was opened by one issue on the part of the European Investment Bank, which raised $100 million in this market. There followed seventeen issues in 1975, and twenty-eight in 1976; the volume peaked at twenty-nine in 1977. The volume since that time has tended to decline; only eight issues were offered in 1980.

There are a number of reasons for this apparent decline but the most logical explanation is the increasing depth and liquidity in the Eurobond market, both primary and secondary, which has enabled issuers to raise money there in large amounts and on terms which compare favorably with those available in New York. A further reason--which I will discuss more fully later on--is the fact that bond markets worldwide have become increasingly volatile and speed is essential if an issuer is to obtain the best possible conditions in the market. Whereas a Eurobond issue can be completed by a sovereign or supranational issuer in a matter of hours, the registration requirements of the SEC, until recently in any event, made the process of raising money in the U.S. market considerably slower. Dollar amounts have reflected the number of issues. In 1977, the peak year, there were $2.3 billion of issues made here by foreigners; the amount in 1980 was less than half of that.

It is not altogether surprising that the Yankee bond market has been dominated by sovereign and supranational borrowers. The number of private sector corporations who have been prepared to undergo the rigors of registration with the SEC is relatively small. In the straight debt sector, European supranational organizations--in other words, the European Economic Community itself, the European Coal and Steel Community, the European Investment Bank, and Eurofima --have accounted for thirty-three issues or just under one-third of the total amount offered, with a total dollar amount of $3.4 billion.

European countries have accounted for forty-three issues, with France being the single most frequent borrower with fourteen issues and Norway having the largest volume with total offerings of $1.25 billion. Other issuers have been Austria, Finland, Sweden, and the United Kingdom. Non-European governments have accounted for twenty-seven issues, with Australia--having done eleven with just under $1 billion--being far and away the most important. Others include Japan, Brazil, Mexico, New Zealand, and Venezuela.

Many of these governments have chosen to borrow indirectly through a state agency guaranteed by the government; others have borrowed in their own names. The credit distinction by investors between these two routes appears to be minimal. Some municipalities have come here, the City of Oslò and the City of Stockholm accounting for three issues between them.

In the straight debt private sector, on the other hand, only three issuers have appeared to date: ICI for two issues, British Petroleum and Ito Yokado, a Japanese retailer, one each.

Let us look now at the equity sector of the market which is, of course, confined to corporate issuers. Since 1974 there have been nine issues of convertible bonds made in this market by foreigners--all of the issuers being located in Japan. The total amount issued was $535 million, and all the issues were made for maturities of fifteen years. There have also been eleven issues of pure equity

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securities, all in the form of American Depository Receipts. Nine of these were for Japanese companies, two for British companies.

C. Changes and Improvements

Why should American investors, given the somewhat disastrous record of foreign borrowers in this market between World War I and World War II, be willing to buy foreign securities in substantial amounts today? I think there are a number of reasons why investors look upon the Yankee bond market today as being dramatically different from that which existed prior to World War II.

First we must remember that most of the issues prior to World War II took place before 1933 and were therefore not subject to the disclosure requirements of the 1933 Securities Act. We should not underestimate the importance of the clean nature of our securities markets. If you are going to invest in securities, you might as well choose a game where the deck is not stacked and the players keep their hands above the table.

Second, the world financial community has changed dramatically since World War II. There is a strong network of interrelating financial connections. Countries that qualify for entry into the U.S. market are among the world's leading industrial nations, and they are normally substantial borrowers in a number of different markets. It is arguable that if one of the major borrowers here--such as France, Norway or Japan--were by any remote possibility to run into problems in servicing its foreign debt, it would undertake emergency loans from the World Bank or the IMF, activate existing inter-governmental swap agreements, run down reserves, tighten belts, cut back imports, or even hold rescheduling discussions with its commercial bank creditors. A whole host of measures would be tried before acknowledging the severity of the crisis by incurring any kind of default in externally funded debt. Continual access to international credit is a country's life blood. To permit curtailment of this access because of an impaired record of debt service would be a national disaster. Corporate issuers are generally based in countries that are themselves well-accepted borrowers in the New York market. Many of these countries have substantial U.S. assets which, although not pledged to secure dollar debt, provide the reserves to service it in an emergency.

This brings me to what I think is the most important distinction between the market today and the market as it existed prior to World War II: that is the willingness of the independent rating agencies in New York to give bond ratings to indebtedness of foreign issuers. This is a relatively new development, but it has become nearly impossible for a foreign issuer to raise money in the New York market without having first obtained a rating--at least if its plan is to issue non-convertible debt.

Of the twenty-one issuers or guarantors that have come to the U.S. market in the last seven years, fifteen have obtained an AAA rating from both agencies; and their borrowings have accounted for $9.6 billion or 87.5 percent of the total amount raised. Two have obtained an AAA from one agency and an AA from the other, accounting for 6.2 percent. One has an AA from both agencies, accounting for $300 million or 2.7 percent, and one has an A from both agencies but borrowed only $20 million. Therefore, borrowers with no rating at all accounted for only 3.4 percent or $370 million of the $10.9 billion raised since 1974.

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The overwhelming majority of business done in this market by foreign borrowers is AAA rated. It is this quality aspect of the borrowings that most appeals to investors here--quality, that is, coupled with an appreciable premium in rate. A foreign sovereign borrower, today, will probably pay as much as one hundred basis points over the Treasury bills of a corresponding maturity; whereas an AAA domestic industrial borrower will pay only forty additional basis points. This differential of sixty basis points represents the so-called "foreign premium": the amount that a foreigner must pay in order to attract the investment interest of U.S. institutions. The investor is therefore able to have, on the one hand, an AAA name on his books while obtaining, on the other hand, a yield significantly higher than that available from comparable domestic credits.

Finally, as I mentioned earlier, bond markets today are volatile. Investors are sophisticated; the days when a bond was bought and held to maturity are now long gone. An advantage of the Yankee bond market is its liquidity. There is a significant and liquid secondary market for Yankee bonds maintained in New York by the principal bond dealing houses; and also, since the vast majority of Yankee bond issues are sovereign credits, these securities are completely fungible with their equivalent issues in the Eurobond market. There is frequent swapping between the two markets, aided by the fact that interest on Yankee bond issues--like interest on Eurobond issues--is paid free of all withholding tax. U.S. corporate and government issues, on the other hand, are subject to the U.S. withholding tax.

3. ADVANTAGES TO THE ISSUER OF THE YANKEE BOND MARKET

A. Characteristics of the Market

Why do foreign issuers use the Yankee bond market? Issuance of a Yankee bond provides entry into the world's largest and most sophisticated capital market. The process of registering with the SEC can be a painful and time consuming one. Nevertheless, once this bridge has been crossed, entities that are substantial users of capital then have access to the broad range of U.S. capital markets, which can frequently provide funds in greater size or on more favorable terms than alternative markets.

Although the use of the commercial paper and private-placement markets does not require long-term debt ratings or registration with the SEC, the completion of these demanding processes provides significant advantages. Continued access is gained to both the debt and equity markets; and access to the commercial paper and private-placement markets is made easier. Finally, the existence of favorable debt ratings and acceptance by U.S. capital markets can serve only to enhance the issuer's standing in other markets.

The two principal quantitative advantages of the Yankee bond market are cost and maturities. The Yankee bond market can frequently provide funds at a lower cost than those available elsewhere. Although the initial costs of market entry are higher than in the case of a Eurobond issue, interest rates are often slightly lower. This fact, combined with the much lower U.S. commission structure, frequently results in a lower end-cost than is obtainable in other dollar markets. Issuers are increasingly cost sensitive. Frequent borrowers want to choose the most competitive market; and it is quite normal for a last minute switch to be made between the Euro-

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market and the Yankee market to take advantage of marginally lower rates.

The second attraction of the U.S. market to foreign borrowers is the availability of long term maturities. Of the 114 issues made since 1974, forty-eight have been for ten years or longer, accounting for $4.4 billion or forty percent of the total. The remainder have been for five, seven, or eight years. Under normal market circumstances the U.S. can provide longer maturities than have usually been available in other markets. Issues with maturities of twenty or even twenty-five years have been successfully offered in the U.S. while fifteen-year issues are considered about the longest maturities obtainable in the Eurobond market.

The main disadvantage of the Yankee bond market is the time, effort, and cost of registering with the SEC. However--as I will discuss in greater detail--these costs are far less for a sovereign issuer. This explains why the great majority of Yankee bond issues have been made by sovereign governments or supranational agencies.

B. Characteristics of the Issues

It is worthwhile pausing for a moment to look at the principal characteristics of Yankee bond issues. First, amounts. Amounts have varied from $20 to $200 million per tranche and up to $350 million per issue (an issue may sometimes consist of two or more tranches of differing maturities). The size of straight Yankee bond issues has been increasing over the past five years. Convertible issues have also ranged in size from $20 million to $100 million. Since issues of less than $75 million do not develop significant secondary market activity, we do not generally recommend offerings of less than that amount.

Yankee bond maturities, as I have already said, range from five to twenty-five years, but it is interesting to note that the two issues for twenty-five years have been for corporations. We have observed that, all other things being equal, American investors will usually prefer a corporate credit as opposed to a government credit of similar rank, particularly when the corporation has significant assets located within the U.S.

One of the reasons why the volume of Yankee bond issues has been declining is that the prevalance of inflation in the U.S. domestic markets has caused investors to seek to shorten the maturity of their exposures. As the overall average life of our domestic bonds goes down, so does the average life of Yankee bonds. The critical comparison between the medium-term Eurobond market and the increasingly medium-term Yankee bond market becomes, therefore, interest costs.

Most Yankee bond issues with maturities of fifteen years or more have typically had sinking funds which have reduced their average lives to around ten years (in the case of fifteen year bonds) or thirteen years (in the case of twenty year bonds). Convertible issues in the Yankee bond market have also had sinking funds, reducing the weighted average life of a fifteen year bond to approximately eight years. Yankee bonds have typically had call protection providing that the bonds will not be callable for a number of years, with the non-call period being as much as twelve years in the case of twenty year bonds. Convertible issues, on the other hand, are typically callable at any time.

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Underwriting discounts and commissions (customarily known as the gross spread) are substantially less for straight debt issues in the Yankee bond market than they are in the Eurobond market. Gross spreads for fifteen to twenty-five year bonds are generally about one and one-quarter percent, and for five to ten year bonds they range from just under seven-eighths to one percent. The gross spread on convertible issues is typically two and one-half percent, about the same as in Europe.

The initial costs of structuring a Yankee bond issue can be quite high. This is particularly true for corporate issuers, since one of the major expenses is the fees for auditors who have to prepare the company's financial statements in a manner acceptable to the SEC. A first time corporate issuer undertaking an equity related offering could find its expenses running close to $1 million. Major items in this expense list would include, for example, about $150,000 for document printing, another $50,000 for printing and engraving securities, anywhere from $200,000 to $300,000 in accountants' fees, probably around half that amount in legal fees, $100,000 in reimbursement of the underwriters' expenses, and other miscellaneous fees including the SEC registration fee, listing fees, blue sky fees, fees of the trustee and paying agent, and fees of the rating agencies.

C. Characteristics of the Investors

Who are the investors in Yankee bonds? The major purchasers of straight Yankee bonds are U.S. institutions. However, the institutional market for Yankee bonds is quite significantly reduced in size by the fact that two key classes of investors are limited in their ability to purchase foreign bonds. Many public pension funds can buy no foreign securities at all. Insurance companies, which could be very substantial purchasers of such securities, are also limited in the amount of overseas investments they can make. This means that performance-oriented bank trust departments and investment advisors are critical to the success of new Yankee bond issues. This factor makes the job of the issuer and the manager in correctly fixing the terms of the issue much more difficult.

If a foreign company has significant operations in the U.S., it may be possible to structure the issue in the form of a domestic offering with a guarantee by the foreign parent. This technique substantially enlarges the potential universe of investors.

For obvious reasons, investment bankers are quite reluctant to reveal precisely where they sell each respective Yankee bond issue or any other bond issue. However, looking at our own retail sales over the last four years, we can see a distinct pattern of distribution emerging. Our own sales account for approximately seven percent of the total amount of Yankee bond issues made during the period under discussion. They are therefore probably a quite accurate reflection of the whole.

Close to eighty percent of our sales have been made domestically; the remaining twenty percent have gone to investors located outside the U.S. The breakdown of our domestic sales is approximately as follows: twenty percent to commercial bank trust departments, five percent to thrift institutions, ten percent to investment funds and investment advisors, six percent to charitable institutions, fourteen percent to insurance companies, twelve percent to pension funds, and thirteen percent to others, including individuals. The proportion of these issues placed within the U.S. will obviously vary according to maturity. For a twenty-year issue the domestically

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placed proportion is considerably higher.

I have mentioned that one of the attractions of the Yankee bond market to borrowers is the possibility of obtaining funds at a somewhat lower cost than might be available in the Eurobond market. If this is true, the converse is also true: investors should be able to obtain a better yield on their money by putting it in Eurobonds. One reason for not putting all one's assets in the higher yielding securities is the desire to develop a reasonable spread of risk between the Yankee and Eurobond markets. In the event that there is a run against the dollar in Europe, the sale of unregistered Eurobonds to European investors may become extremely difficult. On the other hand, it is recognized that there will always exist within the U.S. a reasonably viable market at some price for dollar denominated securities that have been registered with the SEC.

Investors in convertible Yankee bonds typically include a larger number of individuals than would be the case for a non-convertible issue. However, the major portion of the investor group is still institutional, albeit that the previously mentioned restrictions on purchases of foreign securities by pension funds and insurance companies are applicable.

4. REGISTRATION REQUIREMENTS

As I have mentioned several times during the course of my remarks, a major problem that foreign issuers face in the U.S. is in meeting the registration requirements of the SEC. As most of you know, the registration process in general has been considerably simplified over the past several years. A company of stature that has its securities broadly distributed in public hands will generally be what is known as a reporting company, which is a company required to file periodic reports with the SEC pursuant to the Securities Exchange Act of 1934. Such a company, if it meets certain size and other standards, will be able to issue debt securities by registering those securities on Form S-16. This is a short-form registration statement, and most of the information contained in it is incorporated by reference from other documents on file with the SEC. For foreign issuers, however, there is presently no alternative to the basic Form S-1 registration statement, which is a considerably longer and more burdensome document than the S-16.

A. Governmental Issuers

A governmental issuer is entitled to file an S-1 registration statement under what is known as schedule B, which gives the governmental issuer considerable leeway in the extent of its disclosure. For governments, therefore, the SEC problem is not actually the amount of required disclosure. Most of the statistical data that is contained in a governmental S-1 is reasonably available within the various economic and finance ministries. The task is really one of collecting the data and presenting it in a format that satisfies the SEC. Once prepared, however, subsequent registration statements for a sovereign issuer can be prepared with relatively little trouble.

The principal problem that governmental issuers encounter with respect to SEC registration requirements is the lack of flexibility as to timing. A registration statement must be prepared, filed with the SEC, and cleared before any sales of securities can take place. This may take days or weeks in a market that can move significantly in hours. In the Eurobond market, on the other hand, an issue can

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take place in an extremely short time, often on the basis of only a simple offering telex.

Recently the SEC has moved to remedy this problem by means of a so-called shelf registration. A governmental issuer may file this at the beginning of a year and then make an offering by amending the registration statement to reflect, in general, any material developments, underwriting arrangements, and offering terms [1].

B. Corporate Issuers

The real SEC problem concerns corporate issuers who, in addition to filing the S-1 registration statement, will thereafter be required to file reports annually on Form 20-F, which is the foreign equivalent of a domestic issuer's Form 10-K. Despite the fact that the SEC has adopted a quite reasonable and flexible attitude toward the requirements of Forms S-1 and 20-F for foreign registrants, these requirements still present the most severe hurdle: one that keeps many prospective issuers out of our markets.

C. Problems

(i) Accounting

There are several key SEC reporting requirements that create problems for foreign issuers. First is the sheer magnitude and cost of the accounting requirements. This is especially true for companies located in countries whose accounting system differ quite radically from ours, particularly with regard to consolidation.

In those countries where both auditing standards and accounting practices are generally similar to our own--such as, for example, the United Kingdom and the Netherlands--the SEC will normally permit the inclusion of the company's existing financial statements followed by a schedule which reconciles in reasonable detail the financial statements presented with those which would have been required under U.S. generally accepted accounting principles. In practice, this relatively simple procedure can be extremely costly and time consuming. For a company whose existing accounts come nowhere near our own practices, the cost of meeting U.S. auditing standards can be enormous.

(ii) Segment accounting

Another area of dispute is segment accounting. Most U.S. issuers now report on a segment basis with very little difficulty; the outcome, so far as we can tell, has not caused anyone to suffer unduly. However, for a foreign issuer, which may have five or six domestic competitors that do not report on such a basis, the competitive burden of segment reporting can be quite considerable. In addition, we have found several cases of large foreign multinational companies where the requirements of segment reporting have meant a total reordering of their internal data processing systems in order to generate the required information in a timely manner. This, again, is something that represents a continuous burden which can be quite costly and which makes issuers think twice before committing themselves to meeting SEC requirements.

(iii) Executive compensation

One disclosure requirement that is totally accpeted domestically probably raises more questions in the minds of prospective foreign issuers than almost any other. That is the disclosure of executive compensation. As you know, a domestic registration statement requires disclosure of the names of and all remuneration paid

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to the five most highly compensated directors or executive officers whose remuneration exceeds $50,000, as well as the total number of and remuneration to all officers as a group.

In most foreign countries, disclosure of this type is not required, and it is understandable that foreigners are extremely sensitive about this matter. The chairman of a major German or French company would find it both politically embarrassing and possibly--given today's environment--even personally dangerous to have his compensation disclosed in a public document. The SEC has recognized this concern and has shown a very flexible and pragmatic attitude. It has not objected to the disclosure of aggregate executive compensation, without revealing what individuals are paid, unless more detailed information is made public by the registrant in its own country. Nevertheless, we find prospective issuers are still concerned on this account. Once securities are outstanding in this country, they are subject to continuing reporting requirements; and there is concern that what is acceptable now may become more onerous in the future. You may recall that when Form 20-F was first proposed, its requirements were intended to be more consistent with those of Form 10-K than they now are. One proposed requirement, which was shelved after considerable opposition here and abroad, would have resulted in more detailed compensation disclosure.

(iv) Disclosure of foreign payments

One final problem which foreign issuers have with SEC disclosure requirements concerns foreign payments. Corrupt foreign payments which are material either in amount or as an indication of management integrity must be disclosed. However, what is considered to be a corrupt practice in the U.S. may be a normal method of doing business in a foreign country. Indeed, there are many countries that consider the payment of agents' fees or other similar transfers (which we might consider to be improper and therefore disclosable in a registration statement or other SEC report form) to be a part of the normal way of doing business and encourage them as a form of export promotion.

There have been cases where the disclosures required under our securities laws have attracted a considerable degree of unfavorable publicity in the company's domestic country--not because the company did something and was caught at it, but because it was the only company operating out of that country required to make a disclosure of that kind. The possibility of disclosure of agents' fees and other similar payments is something that worries an issuer not only at the time of registration but also in connection with its continuing reporting requirements.

(v) Proposals for change

The SEC, as part of its continuing monitoring of the reporting requirements, has recently circulated a draft proposal requesting comments on the concept of permitting foreign registrants who have securities outstanding in the U.S. market and are already using Form 20-F to report on a regular basis to file for subsequent issues using a much shorter form [2]. One possible system which could be adopted would be very similar to S-16, incorporating by reference information already filed on 20-F. We believe that this could represent a major step forward for foreign issuers and, if adopted, would open up our market. It would not produce an avalanche of new issues, but at least it would make our market more acceptable to those who, while prepared to accept the need to register once under S-1, are reluctant to do so if they have to repeat the same process over and over again for future issues. I urge those of you who have an interest in the future internationalization of our securities markets to write to

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the SEC supporting the kind of liberalization contemplated in this draft.

5. YANKEE EQUITIES

A. Characteristics of the Market

I would like to examine for a moment what we refer to as the Yankee equity: the issuance here of ordinary shares by foreign companies, as opposed to convertible debt or straight debt. Despite the fact that the costs of entering this market are probably higher for Japanese companies than for almost any other type of company--due principally to the substantial expenditure on auditors' fees--Japanese companies have accounted for by far the largest portion, in terms of numbers, of foreign equity issuers here. Over the last seven years there have been share issues by Kyoto Ceramics, Pioneer Electronics, Honda Motors, Waco, Mekita Electric, Kubota, and Trio Kenwood.

The only other country that has provided equity issuers here is the United Kingdom with British Petroleum and Tricentrol, both companies engaged in the oil business. The largest issue was that made by British Petroleum in June 1977, when the Bank of England disposed of part of its holdings in that company. The issue amounted to $215 million--substantially more than any other foreign equity issue in this market, before or since. The size of other issues has tended to be in the $20-30 million range, although Tricentrol, which was the next largest and which I will discuss further in a minute, amounted to $56 million.

Investors in equity issues, as demonstrated by our own retail sales, are very largely the trust departments of commercial banks, accounting for over one quarter of our sales. Investment funds and investment advisors and insurance companies represent the next largest group, followed closely by pension funds. Individuals account for a relatively small proportion of the sales, and sales to overseas investors represent a somewhat larger proportion than is true in the case of straight Yankee bonds.

We find that investors in foreign equity securities are knowledgeable and are making these investments for a number of reasons: (1) obviously, diversification of assets; (2) the opportunity to buy into a market, particularly the Japanese market, which appears to be growing somewhat faster than our own; (3) a diversification of currency risk; (4) at times, the opportunity to buy the growth segment of a particular industry.

For example, Matsushita may today represent the best way of penetrating the healthiest segment of the home entertainment business. At the time of its offering here in 1977, British Petroleum attracted considerable investment interest, since it was then the major international oil company that had the least Arab exposure, its reserves being heavily engaged in both the North Sea and the North Slope.

Yankee equities are typically offered in the form of American Depository Receipts, or ADRs. These receipts evidence ownership of foreign securities, are designed to facilitate the transfer of ownership, and are usually administered by major international banks operating in New York under a depository agreement. They may represent stock on a share-for-share basis. However, where the value of the underlying stock would make the value of one ADR lower than the

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most commonly traded unit values (i.e., between $10 and $30), the ADR may represent a multiple of underlying shares: for example, around ten in the case of Japanese corporations.

The depository agreement is entered into by the issuer and the depository. It empowers the latter to issue receipts and to transfer ownership of the ADRs on its own books and records, while it continues as the official holder of record of the underlying stock on the issuer's books. The ADRs are exchangeable into the respective underlying stock; ADR holders enjoy the same rights, duties, and privileges as holders of stock of the issuer. The ADRs must also be registered under the Securities Act, but if the underlying stock has been registered, registration of the ADR is relatively uncomplicated.

B. Tricentrol: A Case History

I shall relate to you, briefly, a case history of the sale in this market of shares of an important foreign company, tracing it from the moment this company first thought of entering the U.S. market until the time the marketing was successfully completed.

On July 2, 1980, Goldman Sachs was sole U.S. manager on a three million ADR offering for Tricentrol Ltd. with a total value of $55.5 million. Of those three million ADRs, 2.25 million were sold in the U.S. and 750,000 in Canada. This was the first primary offering by a British company--or, indeed, any European company--in the U.S. equity market and only the second equity offering by a European company since the removal of the interest equalization tax. Subsequent to the offering, the ADRs were listed on the New York and Toronto Stock Exchanges.

Goldman Sachs had been advising Tricentrol for a period of two years prior to the offering. Initial discussions with the company had centered on their need--as they perceived it--as an oil and gas company to increase their representation in the U.S., from both a business point of view and a financial point of view, given that the U.S. represented the world's largest capital market with particular sophistication in financing oil and gas companies.

Early discussions with the company had focused on ways to help them develop their business base in the U.S., either through acquisition of companies or through the financing of acquisitions of U.S. reserves to be developed by Tricentrol. Tricentrol viewed the energy business as a multinational one where it is important to have a significant stake in the U.S.; for the U.S. operates as a relatively free market economy in a business where governments increasingly tend to dominate and control the development of natural energy resources.

After looking at various alternatives, the decision was made to forgo trying to achieve both a U.S. shareholder base and an expanded business base in the U.S. in one step through an exchange of stock. It seemed more prudent to achieve the shareholder base first. Then this shareholder base could be used for further acquisitions.

For Tricentrol's stock to be acceptable as an acquisition currency to a U.S. company, it seemed that a registration with the SEC and, preferably, a listing on the New York Stock Exchange after a public offering of stock in the U.S. would be by far the most effective means of achieving this objective. In addition, the funds raised through the offering would be available for additional U.S. acquisition purposes. Tricentrol also decided to take the opportu-

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nity to register the stock in Canada and to have a simultaneous offering in the Canadian market. This offering represents a unique situation in that stock was simultaneously offered in the U.S. and in Canada as an initial public offering in both markets. The prospectus and registration documents met the requirements of the securities laws not only of the U.S. and Canada, but also of the United Kingdom, where the prospectus was also registered.

Once a strategic decision had been made to do a registered offering in the U.S. the process of achieving that registration was both lengthy and complex. The meeting to start work on this process took place in early February and the offering was completed in July: a period of five months. Requirements of the SEC are particularly complex in the case of an oil and gas company, and extensive work was performed by the company's accountants, both internal and external. Added complications were caused by the need to have a firm of independent geologists estimate the reserves of the company in both North America and the North Sea. Furthermore, during the period they were working on the transaction, Tricentrol made an acquisition in the United Kingdom which was so significant that the target company's financial statements had to be included in the registration statement.

As a result of these complications the prospectus contains seventy pages of text and sixty-two pages of financial statements for a total of 132 pages. In addition to the prospectus, almost 3,000 pages of additional material had to be filed with the SEC, some of which involved confidential contracts between Tricentrol and the British government about the development of their North Sea fields. The British government required Tricentrol to negotiate with the SEC to obtain confidential treatment for these documents. As mentioned earlier, the offering was also to be registered in Canada. This called for additional disclosure required by the Canadian Securities Law. Finally, the whole prospectus had to be translated into French in order to meet the requirements of the Quebec Securities Law and thus to be eligible for offering in that province.

In addition to the difficulty of preparing documentation to conform to both U.S. and Canadian requirements, the marketing effort posed similar problems. There are significant differences in the procedures used in the Canadian new-issue distribution process from those that are normal in the U.S. Much time was spent by Goldman Sachs (lead manager of this offering) coordinating with Wood Gundy (the Canadian manager) to ensure that the two different distribution processes were indeed coordinated, so that an offering could be completed on the same day and effectively at the same price.

The Canadian investors were offered shares in Canadian dollars based on a translation of the U.S. dollar offering price. The company and the investors were protected against movements in the foreign exchange market between the time of pricing and the time of payment. The underwriters took out, on behalf of the company, a forward foreign-exchange contract. This covered the difference between the price in Canadian dollars that Canadian investors were to pay for their shares and the price in U.S. dollars that the company was to receive at the time of the closing. Additional discussions took place, particularly with the New York Stock Exchange and the blue sky authorities in the various states in the U.S., for it seems it is common practice in the U.K. for companies to make loans to their officers and this is frowned upon in the various state jurisdictions.

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Clearly, this offering by Tricentrol represented a substantial investment in money and in management time. Nevertheless, substantial benefit resulted from the offering, both in terms of the offering itself and in terms of the company's positioning itself for the future. This is particularly notable because Tricentrol is not the sort of company you would expect to be using the U.S. capital market. It is not in the top tier of international British companies. It is relatively small; and up to this point, it has relied primarily on the U.K. market as a source of capital. At the time of the offering, the company had a total market capitalization of approximately $460 million; and the offering represented more than eleven percent of the number of shares then outstanding. Nevertheless, as this offering indicates, it may turn out that it is the second-tier foreign companies which can obtain the greatest benefit from an equity offering in the U.S.

In Tricentrol's case, some of these benefits are as follows:
(1) An offering of $55.5 million represents a substantial new source of equity capital and reduces the risk that the London market, which had provided equity to the company as recently as 1979, might be unable to meet the company's quite substantial needs.
(2) An offering in the U.S. represents the first step in a program to obtain access to all aspects of the U.S. capital market. The U.S. market is the largest in the world and can be expected to provide additional sources of funds at all times. Reliance on the political and economic status of a single smaller economy is avoided, and registration with the SEC acclimates Tricentrol to the U.S. disclosure requirements in a way that should allow it to meet subsequent obligations relatively easily.
(3) Tricentrol is now in a position to use its stock in connection with the acquisition of a U.S. company. With a New York Stock Exchange listing and a successful U.S. offering behind it, Tricentrol will have a market acceptance with shareholders of potential target companies, which it would not have had without such an offering.
(4) Tricentrol's business strategy calls for increased exposure in the U.S. The publicity associated with the offering and the presentation of Tricentrol in a format familiar to the U.S. business community will facilitate that exposure. It will increase knowledge of Tricentrol among U.S. companies in the oil industry.
(5) In addition to providing sources of funds, the U.S. capital market will be a source of support to Tricentrol in the future. Up to the time of the offering, the company was dependent upon the U.K. equity market--a market that is relatively unsophisticated in evaluating oil and gas companies, particularly those whose assets are located outside the U.K. continental shelf. It is to be expected that at various times in the future U.S. investors will value Tricentrol's assets and earnings more highly than will the U.K. market. This will provide buying support for the stock and thereby facilitate additional equity financing or acquisition through the use of common shares.

6. OTHER MARKETS

In conclusion, I shall touch briefly on two other major capital markets that are of importance to foreign issuers. The first is our commercial paper market. This is a market that really does not exist anywhere else in the world.

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A. Commercial Paper

Commercial paper is unsecured short-term promissory notes, typically used by well-capitalized industrial, commercial, public utility, finance, and bank holding companies. It is sold in the open market, usually on a discounted basis.

Commercial paper has provided a means of short-term financing for over a century and a half, but it has experienced its most rapid growth in recent years. The total value of commercial paper outstanding in the market place has risen from $260 million in the period just after World War II to approximately $125 billion today. At the present time, approximately one thousand major corporations maintain commercial paper ratings from one or more of the three rating agencies. While not all the rated companies are active in the market at the same time, a substantial majority have occasion to come to the market at some time during any given year.

The market is divided into two segments. The first--comprising just over half of the total amount outstanding--is made up of issuers selling their paper directly to investors. These are mainly finance companies, such as GMAC, Ford Motor Credit, and G.E. Credit. The other segment represents issuers whose paper is marketed by a dealer.

Foreign borrowers like the U.S. commercial paper market for a number of reasons. First, it offers a source of funds that has historically been cheaper than alternative borrowing sources such as the London interbank market and the U.S. domestic commercial bank market. Second, it provides a diversification in a company's or a bank's source of dollar funds. Third, it is a flexible instrument in terms of tailoring maturities to the borrower's needs, since paper can be issued in maturities of anything from 5 to 270 days. Last, the issuance of commercial paper is an attractive and relatively easy-to-manage method of gaining access to the U.S. capital markets. Commercial paper is exempt from registration under the Securities Acts. On the other hand, commercial paper does require the issuance of a rating. The highest commercial paper rating generally indicates that the borrower would have a bond rating of at least an AA or possibly a very strong A. Obtaining a commercial paper rating paves the way for ultimately obtaining a long term bond rating. The institutional buyers of commercial paper parallel in many respects those who will ultimately buy a long-term debt issue.

As of the end of last year, approximately eighty-two foreign corporations, government agencies, and banks were using the U.S. commercial paper market. The average reported quarterly value of outstanding commercial paper of these issuers totalled just under $10 billion. The issuers included entities located in Australia, the United Kingdom, France, Switzerland, New Zealand, Japan, Belgium, Finland, Sweden, Germany, Holland, and Denmark. There were major programs by such issuers as British Petroleum, which had close to $1 billion outstanding; Electricité de France, with $1.7 billion; Caisse Nationale de Télécommunication, the French telephone company with $500 million; and the state-owned British Gas Corporation and British National Oil Co., each with just under $250 million.

A recent development in the commercial paper market has been the growing interest of foreign banks in tapping this market. These banks see commercial paper as a method of diversifying their dollar funding, of tapping a broad segment of investors in the U.S., and of obtaining funds at a lower cost than in the European interbank market. Banks such as Barclay's, BNP, Swiss Bank Corp., Union Bank

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of Switzerland, Crédit Lyonnais, and Amsterdam-Roterdam Bank have chosen to adopt this method of financing within the last year or so. Our experience as the leading commercial paper dealer in the U.S. leads us to believe that this method will continue to prove attractive to top-rated foreign borrowers. From the investors' point of view, it represents a convenient and easy method of getting better acquainted with these major companies located outside the U.S.

B. Private-Placement Market

The other market I want to touch on briefly is our domestic private-placement market. This, again, is somewhat unique. Until recently there was really no other place in the world where major borrowers could negotiate directly with lenders and obtain large sums of long-term money on a totally private basis without any aftermarket listing or broad distribution. This private-placement market has not proved to be a very significant source of funds for truly foreign borrowers, since in many cases--as I described in greater detail earlier--the lenders were precluded from lending more than a small proportion of their assets to such borrowers. I strongly believe there is a case to be made for liberalizing these constraints and I am pleased to note that this is already happening in the case of investments in Mexico.

Where the foreign borrower has substantial assets in the U.S., however, his U.S. operations can be treated as a domestic entity for the purpose of meeting the various state legality tests. Through the medium of a guarantee or some other method of support, the parent ensures that the U.S. affiliate has the best possible credit rating and can obtain funds on the most attractive terms. The private-placement market has therefore been popular with foreign companies that are making acquisitions here or are expanding their assets base within the U.S.

The U.S. private-placement market is also a major source of funds for complex projects. Project financing typically relies for credit support on contracts between the project, users of output, suppliers of raw materials, and other sponsors. By fitting together the various components, a viable credit can be created, but one which is complex and therefore difficult to sell in public markets. Accordingly, most project financing in the U.S. is undertaken on a private-placement basis. In addition, where project equipment is to be leased, the U.S. tax laws provide substantial advantages to domestic owners of equipment that may be located in a foreign country. The lessor is still permitted to obtain accelerated depreciation and certain other fiscal advantages, but probably not investment-tax credit. Because of this, sponsors of major projects around the world tend to look toward the U.S. private-placement market if there is any possibility of obtaining funds here on a long-term basis.

Typically, the main constraint is sovereign risk when the project is located in a developing country. However, projects in Australia, New Zealand, the North Sea, Canada, and, more recently, Mexico, have found advantageous financing by using our private-placement market. Goldman Sachs has been responsible, for example, for financing drilling rigs constructed for Pemex to use in offshore oil exploration and development by the Mexican state oil company. These rigs are owned by U.S. lessors. They are leased to Pemex under long term leases, with the related financing being placed with U.S. institutions. Pemex has obtained U.S. financing for substantial capital expenditures by this route.

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In summary, I believe the U.S. capital market represents a sophisticated and vital component of the world capital markets. We hope that issuers will increasingly use the U.S. markets, particularly as regulatory constraints are gradually reduced.

MR. HAWES: Steve Friedman, would you like to make some comments and raise some questions?

7. DISCLOSURE STANDARDS FOR FOREIGNERS

MR. FRIEDMAN: I think the SEC is clearly moving in the direction of integration in the use of shelf registrations and is increasingly confronting the question of differential disclosure for foreign issuers. But in evaluating those judgments, it is useful to keep in mind why we are doing this. Accordingly, my first question for Michael is, why do you think it is in the interest of the U.S. to encourage the use of our capital markets by foreign issuers?

MR. COLES: I think that the flow of capital, like the flow of goods and services, should be a two way street. If we create barriers to the use of our markets by others, it is quite possible that, when we need them most, others might create barriers to our use of their markets.

MR. FRIEDMAN: Michael, excuse me, but disclosure requirements are not barriers. They are inefficiencies in our market as compared to the Eurobond markets. They impose additional costs on raising capital in U.S. markets, but there are no discriminatory barriers against foreigners.

For example, consider the accounting issues. Differential accounting and auditing standards are a very serious problem, although I think it is interesting that the companies for which the accounting issue is probably the most difficult--the Japanese companies--are the ones that have been willing to face up to it and pay for access to our markets. In thinking about how far we ought to go to accommodate other accounting systems, it is important to keep in mind why we are doing so and why it is important to our national interest. Why is it useful for the U.S. to have foreign companies raising capital here?

MR. COLES: With respect to equity issues, if I may answer that first, the question would be, are U.S. investors better served by having an enormous amount of information about a very, very few companies? Or, would they not be better served by having a vastly expanded horizon of companies in which to invest, with a somewhat reduced level of disclosure? It could be argued that it is like--if I may use an analogy--pollution control. Getting the last five percent of dirt out of the air is what costs you the most. I doubt that general conformity to our requirements is the thing that worries foreign issuers the most. The problem is with some of our more marginal requirements, for example, the U.S. existed happily for many, many years without segment reporting being required to meet the disclosure obligations of the securities acts. Now, that is a major problem. We have discussed the disclosure of foreign payments. Again, I believe that the SEC did not necessarily feel this information was essential for investors to know. This disclosure requirement was used more, in our view, as an enforcement technique.

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

I think we would not propose that the overall standards of disclosure required for coming to the U.S. market should be lowered in any significant way. U.S. investors are entitled to a level of disclosure superior to that of the rest of the world; as I said early in my remarks, this is the market where you play with a clean deck. On the other hand, anything we can do to simplify disclosure, to make it easier for companies to meet our requirements without removing the basic premises on which the securities acts were built, would be a positive step.

MR. FRIEDMAN: I find it curious that so few foreign companies are using our market. As I listened to you talk, it became obvious that the problem of regulatory requirements creating undue delays is clearly a very serious one. On the other hand, the volatility of the bond markets is a relatively recent phenomenon, and there was a period of relative interest rate stability after the IET was lifted during which there was not much activity in our markets. You talked about an interest rate differential and a commission differential and I believe you concluded that the net cost of financing in this market for an appropriate company ought to be lower, even granting the higher front-end costs because of regulation.

If we were able to deal with the timing problem through a continuous disclosure system and if we dealt with some of what I will call the irritants in the disclosure system, do you think it is likely that there would be a substantially greater use of our markets by foreign companies?

MR. COLES: I think that the use of our bond markets by foreign companies would not increase dramatically except for companies that deem it necessary to come to the market every year. That is one of the reasons why governmental issues predominate. You swallow the first front-end costs, and from that point onwards that cost is already sunk. You do subsequent issues all the time, and it becomes relatively easy. For a corporation that is going to issue on a one-time-only basis, the Eurobond market will always be more attractive.

MR. FRIEDMAN: In spite of the cost differential?

MR. COLES: The cost on a one-time issue, if you figure in the front-end out-of-pocket costs, will always be higher here than in the Eurobond market. How many European non-governmentally owned companies come to the market for a bond issue every year? Relatively few.

I believe my firm is engaged at the moment in preparing for registration a major foreign company which sees the U.S. market as an insurance policy. As a continuous user of dollars, the company is concerned that somewhere down the road this may be the only game in town for dollars, and it wants to have access to this market. It turned out to be a very expensive insurance policy.

MR. FRIEDMAN: Problems of this nature impose an important discipline because they make us think anew about whether some of the disclosures that we require are really so essential. There is a useful fallout effect for our domestic disclosure system. Nevertheless, I think it is a fair question to ask whether it is worth going through this process for foreign issuers if there are not going to be substantial numbers of them in our markets.

MR. COLES: I think that the greatest expansion would be in

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equity securities, and this is the area that would benefit U.S. investors the most.

MR. FRIEDMAN: I agree with you.

MR. COLES: There are major companies--for example, natural resource companies or companies with unique positions--that are not available in U.S. markets, and it would be very useful to have such exposure here. Again, I go back to my question, do you have a lot of disclosure from very few, or do you lower the standards somewhat --I would not want to see them abolished altogether--and admit many more issuers here?

MR. HAWES: Michael, what are the weights given to the particular concerns expressed by foreign issuers, for example, accounting standards and the disclosure of foreign payments? To what extent are these issuers frightened of the SEC, or are they simply frightened that regulations will change every week or every few months?

MR. COLES: The proposal to amend 20-F, even though it was shelved, did cause an enormous amount of concern.

MR. HAWES: The original proposal. . .

MR. COLES: The original proposal was to amend 20-F, to bring it much more in line with 10-K. The reaction of many of our prospective clients was, "They tried it once, they might try it again. Once we have the securities out here, there is no way we can pull them back. We issue a twenty year bond in the U.S., and it has ten years of call protection; then somebody suddenly says that they want this or this or this in the way of disclosure, and we are stuck with it." That is still a concern.

The other question of great importance to foreign issuers is based on the problems of preparing the first registration. Having lived through it ourselves three times with European companies and several times with Japanese companies, we can tell you that the work involved is incredible. It involves bringing in new management in some cases and new data processing systems. Our clients ask the question: "We understand the general principle under which you are operating; but when you get down to that last five percent which accounts for fifty percent of the cost, is it really necessary?"

MR. FRIEDMAN: Let us assume the Commission were prepared to do something about that. What kind of a process would one adopt to identify that last five percent? The last five percent may vary from company to company and management to management as their sensitivities shift, and it may be difficult to deal with it in a generic way.

MR. HAWES: What are the major segments of the five percent?

MR. COLES: Your proposal for the--I will call it the S-16--goes along the right way because, as a U.S. company knows, it is much easier to prepare a 10-K than it is to prepare an S-1, even though much of the information is the same. If a company has to report to the SEC on a regular basis, I think the ability to submit a short-form registration statement later on will make the initial burden much more palatable. Anything we could do to cut down the minutiae that is required in notes to the financial statement would

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help. The length and bulk of our financial statements are incredible.

Many times the question we are asked is, does anybody read it?

MR. HAWES: One possible answer to the concern of foreign issuers about becoming a reporting company and then having the SEC increase or drastically change the disclosure requirements would be a kind of moratorium. The SEC could provide that it would give foreign issuers the choice of accepting a change in disclosure requirements or of continuing under the old rules for a period, say five years, which would be adequate to allow the foreign issuer to withdraw from the market in an orderly way (*e.g.*, through a tender offer program or redemption).

NOTES:

[1] *See* The Kingdom of Sweden release, named after the government involved. Securities Act Release No. 6240, 45 Fed. Reg. 61,609 (1980).

[2] Securities Act Release No. 6235, 45 Fed. Reg. 63,693 (1980). The International Securities Matters Committee of the American Bar Association wrote a letter commenting very favorably on the possibility of using the concept of world-class companies to categorize those who might be permitted to use simplified registration forms.

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UNITED STATES COMPANIES RAISING CAPITAL ABROAD

Michael von Clemm

1. FINANCING CAPITAL SPENDING

There is a Fortune 500 company, which may indeed be represented here today, whose financing priorities were described to me during the first quarter of 1980 as being size, flexibility, and cost--in that order. The timing is significant: it was the quarter in which the U.S. prime rate reached an unprecedented twenty percent, the quarter in which there was no fixed rate U.S. dollar financing in the Euro-market. There were few companies of any size that felt then that they could afford to put the cost of funds as their third priority.

A. Timing and Cost

In increasingly volatile securities markets, the trade-off between flexibility of timing and the cost at which it is possible to finance capital spending has become ever more important. For companies whose cash flow permits, it is possible to wait out periods of high interest costs, and to place market offerings when the cost and volume of funds are closer in line with the yield of capital investment and the state of balance sheet commitments. But the extent of available bank credit lines and commercial paper placements is not limitless. To use credit facilities designed for the short-term needs of daily cash management for capital financing is to run the risk of being caught by an outflow of funds for business purposes and to be forced into the securities markets at a time when the propsects for fixed rate issues are unpropitious, to say the least.

As it becomes more difficult to predict when a period of appropriately low interest rates will occur (and just what these "appropriate" rates will be) the cost of flexible timing of capital finance reduces the freedom to take business opportunities as they arise. Increasingly, the demands of current operations will limit the extent to which a borrower can afford to expand into profitable activities without taking longer-term high-cost obligations onto a balance sheet. The size of available short-term credit declines as it is used for capital finance; and borrowers have reduced freedom to make choices between long-term funding costs and business demands, making it impossible to extend operations into any area that cannot guarantee a yield that will compensate for the high cost of long-term finance.

You will notice that I have avoided the use of the expression "credit crunch," because I do not want to be quoted as predicting one. In New York you have to be careful how you are quoted. This was discovered by a former Archbishop of Canterbury who on arriving here was met by the press at Idlewild. A bright young reporter in the back row, after the usual questions about the ecumenical movement

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and so and so forth, stood up and asked the Archbishop, "Sir, while you are in New York, are you going to visit any of our strip clubs?" The Archbishop, being well trained for this kind of thing, engaged in the classic ploy of answering a question by asking another question. He said, "Are there any strip clubs in New York?" with holy innocence on his face . . . which disappeared the next morning when he opened the daily newspaper and saw the headline, "Archbishop's first question: are there any strip clubs in New York?"

B. Answers to the Dilemma

There are two solutions to the borrower's dilemma that are available in the domestic finance markets: to extend the size of money-market credit lines, and to issue long-maturity debt with an option to redeem the principal after a relatively short period, using capital raised at lower costs in an improved securities market. Although a borrower is then obliged to pay a high fixed-interest rate, the period over which it is paid is limited to that of a medium-term bond. This provides at least some insurance against the loss of competitive position that would result from a company's being locked into high interest costs while other producers in its industry are able to take advantage of lower interest costs on later borrowings.

(i) Domestic credit lines

The first of these "solutions" is becoming increasingly difficult (and expensive) to achieve as Administration policies against inflation take effect. It is on the banking system, after all, and the volume of its advances that the pressure of monetary policy falls. Banks and money-market dealers cannot be expected to expand their lines of credit as the demand for short-term finance rises. Indeed, since a large proportion of commercial paper is held by corporations, whose own need for cash to finance their internal requirements can be expected to increase, the prospect for a general rise in money-market borrowing by corporations is particularly bad.

Further, there is no need for me to remind you that the cost of borrowing through short-term liabilities reflects the general expectation that eventually interest rates will fall. It is expensive to issue long-term debt. It is even more expensive to borrow from the domestic banking system or the money markets in the short-term, although over the life of a bond issue (even with a relatively short no-call period) the cost of short-term money can be expected to average out at a similar level to that of the bond, while allowing the opportunity to switch into long-term debt should the markets improve. The cost of delaying a securities market financing is measured in terms not only of business opportunities foregone, but also of the cash premium that has to be paid for short-term money at the present time.

(ii) Alternative markets

If a borrower has access to a market in bank credit and dollar securities that is genuinely independent of the domestic markets in which daily cash needs are financed and that takes an independent view of the U.S. economy and, hence, of the interest yields appropriate for dollar investments, these problems, even if they do not disappear, may be lessened. Where securities markets take different views, it may be possible to raise capital at reasonable rates sooner in one market than in another, thus releasing the

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pressure on cash positions before it would otherwise be possible to do so.

Further, the cost of banking finance in the alternative market may also be substantially below that available in the domestic market, making possible the profitable switching of a part of a cash-management program. Above all, a different general outlook, combined with the particular use of funds for capital finance, may make it possible to extend credit lines at relatively low cost during a period of tight money-market conditions. Rollover credits organized in the second market may underpin a flexible capital program without constraining the domestic working-capital program of a company. Both would cost less in terms of financing costs and would leave the borrower poised to take advantage of whichever securities market may be the first to make capital finance available at the "appropriate cost".

The independence of such a market obviously presupposes freedom from the monetary policies and regulations that limit the availability of funds in the domestic market. In order that the pricing of funds differ, it is also necessary that the outlook of investors be different from those in the domestic markets. This cannot be achieved without crossing administrative boundaries; and increasingly, borrowers who are looking for a source of funds that fits these criteria have been raising capital abroad.

C. Transnational Financing

The international financial market has developed since 1964 into the second largest source of available funds on earth. The estimated $1,450 billion of transnational financings break down into three groups. These are (1) the holdings of equity by non-nationals, (2) the internationally placed medium-term notes and bonds, and (3) the syndicated international bank credits. In addition, there is an international market in the credits of the banking system itself --including central banks and government placements--which is as yet of limited relevance to corporate borrowing needs.

The gross foreign purchase of U.S. equities in 1980 reached $74 billion. This has more than doubled the 1977 total of $26 billion in only three years and this interest in U.S. equities appears to be continuously increasing.

During 1980 the total volume of medium-term financing raised through securities issues and bank-loan syndications placed on an international basis was over $107 billion, without taking into account issues organized for foreigners in the domestic markets. Issues of dollar bonds for international borrowers totaled over $16.25 billion, of which more than half were placed with investors in the Euro-market and the remainder were syndicated in various domestic financial markets around the world. During the peak of the securities market's explosion of activity in the second quarter of last year--in June--$5 billion worth of debt issues were placed in the international market, compared with $7 billion placed in New York.

In 1980 there were some sixty-seven debt issues by North American corporations, of which sixty-one corporations were actually domiciled in the U.S. The value of those issues was $4.1 billion, and it is interesting to compare that figure to the value of comparable borrowings in 1975, the first year after the removal of the

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interest equalization tax and the year of the full effect of the first big jump in oil price rises. In 1975 U.S. corporations issued $268 million worth of debt securities abroad--$268 million versus $4.1 billion last year.

Although figures for the securities markets compare favorably with the rate of capital formation in any domestic market, they are dwarfed by the volume of credit syndication over the same period. In 1979 the equivalent of $102.5 billion was raised in the Euro-market; in 1980, $89.1 billion. These enormous volumes are inflated by heavy borrowings by national agencies of countries with large balance of payments deficits with the U.S. But a large number of syndications, ranging from a $3 billion credit for Seagrams to credits for much smaller amounts ($20 million and upwards), have been arranged for corporate borrowers who have come to realize that the cost advantages and, more important, the strategic advantages of borrowing in the international markets are too great to be ignored.

2. THE INTERNATIONAL MARKET

A. The Relationship Between U.S. Markets and Euro-Markets

The different trade-offs between cost and availability of funds in the domestic and international markets indicate two major differences of outlook between U.S. and Euro-market investors. These involve, first, the valuation of a securities portfolio in terms of the performance of alternative currencies as well as alternative investments and, second, the views of various domestic economic policies taken by investors who have experience with Western European economic management.

There are also limits on arbitrage between the markets represented by barriers to the free flow of capital. Until 1974, when the controls on foreign borrowing in New York that had been imposed by the Democratic Administration in the early sixties were removed, a large proportion of the financing of even the foreign operations of domestic corporations had to be organized abroad. The office of Foreign Direct Investments limited outflows of capital; and the interest equalization tax was intended to limit the interest advantages available to foreign investors in New York compared to their domestic markets. The opportunity for domestic investors to buy international debt did not exist.

Since 1974, the possibility of arbitrage by domestic investors has limited the extent to which yields on the Eurodollar market can be expected to rise above those available in New York. A large increase in income that an investor can gain simply by transferring dollars into international securities will not continue where there is no risk at all on the arbitrage.

The really effective barrier to the transfer of international dollar holdings into the domestic market--which was not abolished with the interest equalization tax--has been the withholding at source of the basic rate of domestic income tax on dividends and interest payments of companies domiciled in the U.S. By reducing the yield on a foreigner's investment in the U.S. by up to thirty percent, this tax penalty means that there can be, in theory, a difference of thirty percent in interest rates before domestic issues become attractive. The difference has never actually approached such levels; but, on the other hand, the differentials

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that do open up can be very, very interesting indeed. Just consider the credit market in May of last year. The difference between the U.S. prime rate and the London interbank offered rate (the basis on which all Euro-credits are fixed or priced) widened in May 1980 to 5.3 percent. This difference was almost one third of the rate payable in New York at that time. There is an obvious advantage to raising funds in the international market when this happens; and discrepancies of this size do not, therefore, last long.

As borrowers take advantage of the gap, a large number of consequences develop that can be expected to equalize funding costs. As we have already seen, this happened in June 1980. The $5 billion of issues (out of a total of $12 billion) that were placed in the Euro-market that month peaked at a coupon of 9.5 percent, rates that were thirty basis points better than the best levels reached in the domestic bond market when it peaked that same month.

B. Leadership of the International Market

What was important in the bull market of the second quarter of 1980 was not so much the actual rates that each market ultimately reached, but the leadership of the international market in reacting to the trends in the financial futures markets as the second quarter began. The first issue to be priced at a substantial discount over that expected in the market was an international issue for GMAC. It was followed by a highly successful offering for J.C. Penney which, though priced well below the rates then available in New York, was increased by one third and remained oversubscribed. This pattern of the Eurobond market making its own policy decisions and leading New York is one that--for reasons I shall discuss later --we may find repeating itself.

It is not possible to attribute this to changes in exchange rates, permitting investors who value their assets in foreign currency to make allowance for the capital gain on their holdings when the dollar appreciates. The increasing liberalization of exchange controls, together with a growing volume of major-currency holdings outside the domestic economies of many large OECD nations as they move into balance-of-payments deficit, has made it increasingly easy for international investors to move their portfolios from one currency to another and take advantage of expected changes in relative exchange rates. As a result, Euro-market participants have come to value debt holdings not only in terms of the yield on the asset, but also in relation to their expectations of the trends affecting rates of exchange. These are not necessarily the same factors as those that dominate the pricing of finance purely in terms of interest cost on the New York securities market; and they naturally include a political as well as an economic assessment of a country's future.

During the drop in interest yields in the second quarter of 1980, this factor brought strong pressure on the Euro-market to limit its enthusiasm for dollar capital. As interest rates declined, the dollar exchange rate weakened and then fell dramatically in comparison to a variety of European currencies. Far from compensating for the loss in income, this further penalized holders of dollar issues, cutting the domestic value of their yields and holdings. The pressure of demand for securities developed in spite of, rather than because of, changes in the exchange rate.

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It is in the other priorities of investors in the international markets--their view of the outlook for the American economy and the structure of their portfolios--that an explanation is to be found. Investors and investment managers represent a spectrum of needs, while the mix of transnational issuers whose debt is available also differs from the risks represented by purely domestic borrowers. Since the degree of risk taken by a portfolio manager is, in part, a function of the variety of issuers represented in the portfolio--as well as the credit of any individual borrower represented in it--the relative valuation a specific issuer of debt can make a dramatic difference in the issue's reception.

C. Access to the International Market

(i) Role of the universal banks

The syndication of an international banking credit has one further advantage as part of a financing program in today's markets. It is as part of an overall debt portfolio that banking credits are available in the international market. The institutions that handle banking finance are also those responsible for the placement of bond issues in the international market. It is therefore possible to use a credit as a vehicle through which to approach the bond market.

If you look at a tombstone advertisement announcing the consummation of a Euro-market bond issue, you will find it dominated by universal banks with a commercial-banking arm, which here in the U.S. would be prohibited under the Glass-Steagall regulations. These banks are themselves large takers of international debt, both on their own behalf and on behalf of clients whose portfolios they manage. They also maintain close relations with the major investment managers and investors in their markets and, together with the investment banks of established reputation in the market--of whom there are relatively few--they are in a position to sponsor newcomers in placing debt with retail investors.

In the securities market this sponsorship is important because there is no institutional system for rating credit comparable to that used in New York. Unless investors receive personal advice about a borrower's credit, it will not be possible to place debt with them, for there is no general class of debt assessment in terms of which it is possible to analyze risk. This means that the relationship between retail investors and the underwriting and managing banks in the Euro-markets is as much one of investment advice as straightforward offers of securities of a particular known quality. Because few retail investors have the apparatus at their disposal to assess credit themselves, the banks, acting as sponsors, must bring the quality of an issuer to their attention. To ensure a wide and ready market for a company's securities it is necessary that a representative cross-section of the banks with securities market relationships be aware of its credit. And there are few better ways of ensuring that awareness than the syndication of a banking credit among them.

The importance of personal contact to the international market is illustrated by the fate that befell the Eurodollar commercial paper market in the early part of the last decade. Despite the savings in cost that could be achieved by reducing the dependence of borrowers on banks for their short-term financing, European companies were not interested in weakening their relationships. The personal contact with their banker was an asset for which, they

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believed, the reduced interest costs of a commercial-paper market could not compensate.

In part, because of the nature of their relationship with borrowers domiciled in Europe, underwriters and managers in the international market will want an opportunity to meet the senior executives of an American newcomer. For them the assessment of a company means coming to know its officers--personally--as well as the state of its corporate balance sheet. Any investment banker concerned for the success of the future development of a funding program in the Euro-market will arrange a series of meetings in such centers as London, Zurich, and Frankfurt during the syndication of a credit.

I wish to make one quick point here. At present there are outstanding 3,243 Eurobond issues, and there are approximately one thousand Eurobond issues that have already matured. That is about four and one half thousand separate issues, though a number of those are repeat transactions for the same borrower. Of that number of issues there are only eighteen delinquencies or defaults. Of those eighteen delinquencies or defaults, it is my recollection that approximately seventeen are by U.S. corporations that are subject to SEC overview.

(ii) Cost of international funding

The cost of a funding program compares very favorably with that available in New York. If you compare the rates payable on three-month drawings of comparable banking credits in Europe and New York--prime with ten percent compensating balances in New York against three-month LIBOR plus a three eighths percent margin in the international market--the average margin in favor of LIBOR over the past five years has been 147 basis points. At its widest, the margin has been over 6.75 percent and the LIBOR rate has never been above that fixed against prime during that period.

For a bond issue also, the cost of raising capital in the Eurodollar market has been below that in New York on many occasions during the past two years. The yields on, for example, two GMAC issues maturing in 1984--one a triple A rated domestic, the other a Eurobond--have been lower in the Euro-market for over half the business days during the past two years, including, of course, the beginning of the bull market in the second quarter of 1980.

The mechanics of an issue are determined by the need to free investors from tax obligations outside their home countries, and in particular to avoid the withholding tax on income from the securities of companies domiciled in the U.S. Obviously this cannot easily be done for equity issues, for which international investors have to come to New York. But for a bond or convertible issue it is possible to arrange a financing subsidiary outside the U.S. through which the funds can be transmitted to the parent without incurring a tax liability for the investor. For this, a domicile that has a reciprocal tax agreement with the U.S. government is necessary, the most convenient one being the Netherlands Antilles.

A corporation using this market for the first time through a banking credit would be well advised to establish an issuing subsidiary at the same time, in preparation for opportunities that may develop at very short notice. With an established reputation and an organization capable of handling the mechanics of a Euro-issue, a company has access to an alternative source of capital, which can

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be used both to supplement present credit arrangements and to guarantee access to medium-term capital as soon as interest costs fall to an acceptable level.

(iii) Criteria for participation

I started with the dilemma that occurs when capital-market interest rates reach a level that forces the financing of capital expenditure, as far as possible, out of short-term financial instruments, while at the same time the government is tightening monetary policy. In order to ensure the availability of finance as it is needed, it would be invaluable to have access to an alternative and competitive source of capital--one that can be expected to react to improvements in the economic outlook even more quickly than the domestic markets. The international market provides just such an alternative.

MR. HAWES: Do you mean to imply anything by your comment on the limited number of defaults in the international market?

MR. VON CLEMM: I want to say only that without an SEC and without 150-page prospectuses, so far the record of the sponsoring institutions--the universal banks that dominate the Euro-market--is something that should attract at least grudging admiration, if not full-scale admiration.

MR. HAWES: Do you attribute that record to bank screening of issues?

MR. VON CLEMM: There is another side to that question. It is not too hard to get that kind of a record if you do not do business with companies that would be rated in this country below the level of, let us say, single A. There are some transactions that have been done for lesser credits, but you can make a fairly good record if you will not do business with most people in the world. The Euro-capital market is a completely useless allocator of resources when it comes to young and new ventures. I believe that is unfortunate and something that ought to be worked on.

However, a great many of the four and one half thousand names that have been introduced to the international market over the last fifteen or twenty years were not terribly well known at the time they were introduced. Without the sponsorship of these very potent universal banking institutions (they need not be the lead manager but they have to be well represented in the sponsoring group) many of those securities would not have been placed. Not that they could not have been placed at all; it is a question of relative pricing. U.S. corporations are not going to do an issue in the Eurobond market unless they can get the money at a cheaper net cost. We are talking about what it is that opens up the alternative capital market by making funds available at a cheaper net cost than is available elsewhere.

MR. HAWES: Michael, would you pause one moment and characterize either the companies that have come to the Eurobond market, or the companies that should come, or maybe the ones that should not? Is there a level of U.S. ratings, for example, that would suggest that one can make it in the Eurobond market?

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MR. VON CLEMM: Until now it has been the case, by and large, that companies with less than a BAA rating in the U.S. have not appeared frequently in our market. That is the line below which people start to ask a great many questions, the first of which is, why are they coming to the Eurobond market? The image of the U.S. company and its banker as being a pair of well-heeled carpetbaggers is one that does tend to bubble up to the surface of people's minds from time to time. One has to say, however, that with the U.S. absence from the market for the whole period from 1974 until about 1979, Euro-investors realized that they were getting shorter and shorter of U.S. sovereign-risk credits and U.S. corporate credits in their portfolios, and they have been in a generally hospitable frame of mind for the last two or three years.

To give some examples of companies that are using the market, there was a convertible bond issue for Pepsico which was signed in London about three or four days ago. Again, there is an issue being introduced to the market for Southern California Edison. This is very unusual, because in the whole history of the market I think there has been only one other U.S. electric utility that has come to the Euro-market--and that was so long ago, the issue has probably matured by now. We believe that following Southern California Edison there will be a substantial number of U.S. utilities that will learn that this is an alternative market which they should not ignore. Southern California Edison, by the way, has been very well accepted. There was a lot of nervousness about whether European investors even remembered what U.S. utilities were. While a lot of equity in U.S. utilities was held by foreign investors right after the war, it tended to be disinvested over the last fifteen years or so. But this issue and this name have been well received, and there will be others.

MR. HAWES: We have one last comment by Steve Friedman.

MR. FRIEDMAN: It is actually a question. Michael, what is the level of straight equity financing in the Eurodollar market? Is it increasing?

MR. VON CLEMM: To my recollection, there has been one Euro-equity issue done. There are convertible bond issues with warrants, but there has been only one pure Euro-equity deal done.

MR. FRIEDMAN: Why is that?

MR. VON CLEMM: The one pure Euro-equity was Investors Overseas Management.

MR. FRIEDMAN: Are the convertibles seen by their issuers primarily as equity or debt financings?

MR. VON CLEMM: I think there is no single answer to that. Certainly, in our view, those who insist on a twenty percent premium cannot possibly be thinking of them as equity financings. There are others, most likely non-U.S. issuers of convertibles, who accept a five percent premium and they obviously do consider those as equity transactions.

MR. HAWES: I just asked Michael Coles if he had anything to add. Do you have a comment?

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MR. COLES: I would reinforce what Michael said about timing. The markets do different things at different times. They act independently. Going back to June 1980 when interest rates in both markets came down very, very rapidly--the ability to move on an almost overnight basis in a rapidly declining market obviously helped issuers in the Eurobond market as opposed to those in the U.S. markets.

MR. VON CLEMM: Maybe I should add, since I gave the recent examples, that the Pepsico deal was decided here late Friday night and it was introduced to the market in London on Monday morning. It was signed on Tuesday evening; that is a forty-eight hour turnaround. It is not terribly pleasant for the people who have to carry it out, but it is rather a positive feature of the Eurobond market.

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RESTRICTIONS ON FOREIGN INVESTMENT: DEVELOPMENTS IN UNITED STATES LAW

David W. Heleniak

MR. HELENIAK: The topic of restrictions on foreign investments in the U.S. is obviously something that cannot be dealt with in any detailed manner in this presentation, but I think it is essential in a conference devoted to discussing the liberalization and increasing internationalization of capital flows that we remind ourselves that there remain, and indeed in the future may be more, restrictions on flows of capital between countries.

My comments will be directed almost exclusively at one type of investment. Unlike our earlier speakers, I will be principally focusing on the consequences of direct foreign investment, that is, the acquisition of controlling equity interests in U.S. corporations or property. This topic has been of great interest throughout the seventies and into the early eighties in international economic planning on the part of the U.S. government. My former Treasury colleagues on today's panel and that of yesterday, a number of you in the audience, and I spent a certain amount of our time during the previous Administration worrying about the consequences of foreign investment in the U.S. and whether or not those consequences were such that one should be doing something different in the policy area.

Bob Mundheim pointed out to me in the corridor yesterday that the imposition of restrictions on foreign investment remains an idea of great currency, citing the Canadian-Pacific-Hobart tender offer which promptly led to Congressional hearings and the Seagram bid for St. Josephs. Had he had a little more time yesterday morning to read the *New York Times*, he would have noted that it has been alleged that the Prudential bid for Bache was an effort to preclude the Belzberg brothers of Canada from acquiring the same target. Two years ago, when Bob and I first talked about this subject, he was concerned about the proposed acquisition of the neighborhood Woolworth's by Canadian interests. I wonder what the Canadians would make of this great concern in the U.S. over control of our productive resources by Canadians.

1. TRADITIONAL POLICY OF LIBERALISM

Although the direction of our policy may be undergoing reassessment in light of these acquisitions, the essential fact to remember is that our country remains relatively open to foreign investment. Foreign investment has been attracted to the U.S. by the inherent strength of the U.S. economy, the breadth and resiliency of U.S. capital markets, and the fundamental protections of our legal system. These attractions were enhanced in the 1970s by the relative decline of the dollar and the stagnation of U.S. equity prices. Foreign investors have benefited from an essentially open-door policy for investment in the U.S. and, in some instances, from comparative advantages over competing U.S. domestic suitors of investment

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opportunities.

A. Foundations of the Open Door

The historical liberalism of U.S. government policy toward foreign investment is rooted in two fundamental premises. First, the investment process is likely to work most efficiently in the absence of direct government intervention. Second, investors should be accorded national or neutral treatment in making investment decisions, receiving neither preferential nor discriminatory treatment. Once an investment is made here it should be treated on equal footing with other enterprises.

This policy has enjoyed bipartisan support which has been based on a pragmatic assessment of the national interest as well as on philosophic premises. U.S. investment abroad, which far exceeds foreign investment in the U.S., might be adversely affected by restrictions on foreign investment here. As Michael Coles noted earlier, restrictive policies here can lead to reciprocal treatment abroad. In addition, foreign capital can play an important role in increasing productive capacity, competition, and jobs. Many state governments have found these attractions so appealing that, despite efforts of the federal government to discourage the practice, they have competed with one another to attract foreign investment with various tax and other incentives.

Because of the open door policy, when foreign clients come to their American lawyers to seek advice on U.S. acquisitions, the advice generally consists--with a few exceptions that I will mention shortly--of the same advice that is given to a U.S. purchaser considering making an acquisition. In the case of a foreign client unfamiliar with U.S. securities laws, the advice is laced with educational materials trying to explain the vagaries of Mr. Friedman's Commission. We do not, however, have to concern ourselves with any national entity that will pass on whether or not a foreign investor should be allowed to make a particular U.S. acquisition.

B. The Power to Regulate

Although the U.S. has generally pursued a policy of neutrality with respect to foreign investment, the Congress and the executive branch have broad powers to regulate such investment under the commerce clause of the federal Constitution and under the constitutional provisions relating to the maintenance of national defense and the conduct of foreign policy. To a lesser degree the states also have power to regulate and restrict foreign investment. These powers have been exercised sparingly, but to the extent they have been exercised, they represent pitfalls for the unwary.

C. Exceptions to the Open-Door Policy

The exceptions to our open-door policy, to which I just referred, relate primarily to licensing requirements and limitations on foreign acquisitions of real estate or rights relating to real estate. Foreigners interested in U.S. acquisitions and, more important, their U.S. counsel must remain alert to legal inhibitions in these areas in the context of particular acquisition programs.

(i) Federal restrictions in particular industries

The U.S. has a small but important body of law that sharply restricts, precludes, or requires licensing of, foreign ownership

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in certain sectors of the economy--the aviation, communications, maritime and nuclear energy industries, and defense contracting activities. The materials listed in the Bibliography appended to this chapter should be consulted for a detailed description of such legislation. Each of these sectors is, or has historically been, heavily regulated; and, in most instances, obvious and compelling national security interests dictate separate treatment for foreign investors. None of the special legislation concerning foreign investment in these sectors appears to have developed in response to a particular acquisition or to be directed against investors of a particular nationality.

The requirements of these statutes are complex, made more abstruse by a labyrinth of implementing regulations and uneven implementation of the regulations. In some matters lawyers have, of necessity, become so cautious that they are unwilling to give legal opinions, directing their clients instead to the more cumbersome process of regulatory rulings. Results appear on occasion to have been completely unintended by the Congress. For example, leveraged lease transactions, unheard of when federal aviation and maritime statutes were enacted, have become a common means of acquisition of commercial aircraft and maritime vessels. In such transactions, a financial institution, as owner-trustee, occupies a normally passive role with respect to the operation of the aircraft or vessels. Nevertheless, in the case of aircraft, for example, the Federal Aviation Act of 1958 and regulations thereunder have been deemed to require the substitution of a new owner-trustee when twenty-five percent of the voting stock of the U.S. corporation acting as owner-trustee has been acquired by foreign persons.

Given the conglomerate nature of much of American enterprise, a foreign investor must carefully examine all of the business activities of a potential acquisition target to determine whether its business depends materially on government licenses or regulatory permits that cannot be issued to foreign-owned enterprises. You will note that most tender offers by foreigners include a preliminary determination as to the material dependence of the business of the target corporation on licenses that might be adversely affected by foreign ownership. If the loss of such licenses as a result of an acquisition might cause material adverse effects on the business of the target, the prospective investor must confront serious issues which will vary according to the means and extent of acquisition. Where restrictions may be applicable, it is imperative to determine before making or abandoning an investment whether such restrictions can be avoided or accommodated (for example, by operating through a U.S. entity, or establishing a voting trust with U.S. trustees) or if post-acquisition divestiture is feasible without incurring penalties or losing the benefits of the acquisition.

Some domestic corporations have taken advantage of this dilemma for prospective foreign suitors in their defensive planning against takeover bids. For example, Section 5-703(b) of the corporation law of the State of Maryland deals with Maryland corporations that conduct business under a federal or Maryland license or grant of authority which may be restricted, limited, or revoked if a specified percentage of its voting interests is owned or controlled by aliens. Such corporations are expressly permitted to adopt a bylaw provision restricting the transferability, ownership, or voting rights of shares held or to be held by aliens to comply with such license or grant of authority. Under this statute, corporations have adopted bylaws prohibiting the transfer or voting of shares of

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their stock by aliens in an amount that would violate the ownership or control requirements of a particular regulated activity in which the corporation is engaged or even an activity in which the corporation intends to be engaged. Such restraints on alienation of voting securities are not widespread and have not been judicially tested. Presumably the validity of such provisions will be determined by the reasonableness of the restrictions imposed, taking into consideration all of an entity's business activities.

(ii) Restrictions on real property ownership

The other significant area where foreign investors meet unusual problems relating to their nationality is in the acquisition of U.S. real estate. At the federal level, far-reaching prohibitions, which are no longer meaningful, were imposed in the nineteenth century on land acquisition by aliens in the Western territories. There remain, however, significant restrictions under the Mineral Leasing Act of 1920 and related statutes, which provide that rights of way over federal land for oil pipelines and the acquisition of lease rights or other dispositions of interest with respect to coal, oil, and various other minerals on federal lands may be granted, leased, or sold only to U.S. citizens or corporations. The Federal Land Policy and Management Act of 1976 prohibits the sale of public lands to aliens or corporations not subject to the laws of the U.S. or of any state.

Real property law in the U.S. is generally a matter of state law and is not uniform. Alien land laws, restricting foreign ownership of land, date from the initial reception of the English common law by the colonies and are widespread (a majority of the states have such laws), particularly with respect to agricultural land. Recently, states have been enacting new or further restrictions. The power of the states to impose restrictions on alien land ownership has been upheld in both federal and state courts against attacks under the equal protection clause of the federal Constitution and applicable treaties. Nevertheless, the prohibitions may often be avoided, for example, by operating through a U.S. corporation; and in some instances they may be susceptible to legal challenge.

Foreign investors have been following recent developments in the state of Oklahoma with considerable interest. In September 1979, the Attorney General of Oklahoma withdrew a 1975 opinion of his office and concluded that an alien, including a corporation, could not directly or indirectly acquire title to or own land in Oklahoma under the state constitution, except for limited periods of time in the case of *bona fide* residents or through devise, descent, or foreclosure. Title conveyed in contravention of such law was declared to have escheated to the state. The state then commenced escheat proceedings against certain foreign corporations owning real estate in Oklahoma. A state district court held in February 1980, that that Oklahoma law was inapplicable to domesticated foreign corporations. That case had been pending on expedited appeal before the Oklahoma Supreme Court for more than a year. Recently the Supreme Court of Oklahoma held--I have been told, but have not yet read the opinion--that a foreign corporation that qualifies to do business in Oklahoma will be considered a *bona fide* resident of that state and entitled to enjoy the same benefits as any other resident in terms of real estate ownership.

Those are the principal areas, historically, where the U.S. has imposed restrictions on foreign investment. My topic today

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is to concentrate on current developments in U.S. law with respect to foreign ownership.

2. POLITICAL CONCERN OVER FOREIGN INVESTMENT

Political concern over foreign investment has increased during the past decade, hand in hand with the rising tide of foreign investment. The decline of the dollar in the new era of floating exchange rates facilitated an acceleration in foreign investment in the U.S. through most of the 1970s. Dollar-denominated assets became relatively inexpensive; and in some instances, competitive, or political necessities dictated that foreign producers establish production facilities in the U.S. to preserve market shares otherwise threatened by the increasing dollar prices of their exports to the U.S. or by proposed trade protectionist measures. The emerging wealth of OPEC countries further contributed to the flow of funds.

This concern reflects, to varying degrees, (1) xenophobic pressures and prejudices against some nationalities, (2) responses to competitive threats or takeover pressures (particularly in the banking industry, where artificial geographic limitations on domestic bank expansion have limited the exposure of medium and large banks and bank holding companies that are potential takeover targets for foreign banks, it has been suggested that some domestic banks want to inhibit acquisitions by foreign banks in order to preserve domestic takeover targets for a time when geographic limitations on bank expansion are liberalized), and (3) grappling with the complex and historically difficult problems of the accommodation of transfers of real wealth between nations without temporary and irrational distortions of international capital markets.

The U.S. Congress and state legislatures have seen a spate of legislative proposals over the past decade designed to respond to these concerns. The prescriptions for the perceived ills of foreign investment have included such varied approaches as (1) imposing direct limits on the percentage of foreign ownership of public companies in general or companies in particular industries, (2) establishing a commission to prohibit or screen certain foreign investments or to review foreign investments in general, (3) attempting to eliminate advantages foreign investors have been accorded inadvertently over domestic competitors, (4) proposing state legislation to enable corporations to restrict the transfer of their voting stock to foreigners where such transfers might adversely affect the ability to compete in certain business activities, (5) imposing further limitations on alien land acquisition at both federal and state levels, (6) implementing investment moratoriums to permit studies on the effects of foreign investment, (7) providing for disclosure and reporting of foreign investment and collection of data with respect thereto, and (8) instituting a reciprocity requirement restricting foreign investors to the same types of investments in the U.S. as U.S. investors may make in their home countries.

3. RESTRICTIONS ON FOREIGN INVESTMENT

I am delighted to report that at the federal level successive Congresses, with the strong encouragement of Republican and Democratic administrations, have resisted the more draconian proposals. The legislation that has been enacted at the federal level during the past few years, I think fits into two broad categories. The

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first category represents an effort to enhance the statistical base available to policy planners; and the second is the area that Bob Carswell referred to previously as trying to make the playing field even--that is, addressing areas of U.S. legislation that have accorded disparate treatment between U.S. and foreign investors with a view to removing the differences.

A. Reporting Requirements

The origin of reporting statutes can be traced to the early seventies when dollar-denominated assets began to look increasingly attractive and there was concern within the Congress about possible OPEC acquisitions. The executive branch, in trying to make some intelligent decisions as to whether or not the level of investment was substantial enough to warrant some concern, and to be able to document its views on the subject in a sensible way to the Congress, discovered that we did not have a good statistical base within the U.S. concerning the degree of foreign investment. Beginning with the Foreign Investment Study Act of 1974 the U.S. government commenced the arduous task of compiling a statistical base on foreign investment. The International Investment Survey Act of 1976 [IISA] has established a permanent basis for providing every five years a survey of foreign direct investment (acquisition of ten percent or more of the voting securities of a business enterprise) and portfolio investment in the U.S. The Treasury Department has recently published the results of the first portfolio survey, which was conducted in 1980. In January the Commerce Department published for comment an instruction booklet and regulations for the conduct of the first direct investment survey, which is scheduled for the first half of 1981, together with amendments proposed for quarterly and other reporting forms.

In addition to the reporting requirements imposed under IISA, the Commerce Department has established numerous periodic and extraordinary reporting requirements under IISA applicable to enterprises in which foreigners invest and to persons assisting such investment. The reports that have been required have been criticized because they appear to go beyond the informational needs to which the statute is addressed--this despite the express statutory provision that it is not intended to inhibit foreign investment here in any way. In particular, reporting requirements have in the past required identification of the name of an acquirer, whereas only the home state of the acquirer seems necessary for policy planning purposes. In the regulations proposed for the first IISA survey, the Commerce Department has asked for comments on its ability to dispense with the name requirement in favor of simply a nationality requirement. IISA itself has also been criticized for the detailed reporting information it requires.

Similarly, detailed reporting requirements have been imposed under the Agricultural Foreign Investment Disclosure Act of 1978 [AFIDA] with respect to foreign ownership and acquisition of land used for agricultural, forestry, or timber products. Unlike IISA which effectively limits disclosure of particular acquisitions to the federal government alone, AFIDA permits public disclosure of information filed with respect to particular acquisitions. AFIDA imposes an obligation that, within ten days of the filing of a report of an acquisition, the report must become publicly available not only in Washington, but also within the state in which the acquisition occurred. Accordingly, the ability of foreign investors to assemble significant parcels of land is likely to be adversely

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affected by the disclosure of partial acquisitions and their purchase prices, prior to completion of assembly. Substantial penalties, including civil fines of up to twenty-five percent of the fair market value of the interest acquired, may be imposed for failure to report under AFIDA. The results of the first survey under AFIDA, published by the Department of Agriculture in November 1980, indicate that less than one-half of one percent of privately held agricultural land in the U.S. is foreign-owned. The benefits of this information must be weighed in the context of the costs imposed by AFIDA on foreign investors.

The Domestic and Foreign Investment Improved Disclosure Act of 1977, which was enacted with the Foreign Corrupt Practices Act, has also expanded the reporting requirements imposed on foreign and domestic investors by increasing the instances in which reports must be filed with the SEC under the Securities Exchange Act of 1934, disclosing the beneficial ownership of five percent or more of each class of an issuer's equity securities. I will discuss the reporting requirements of the newly enacted Foreign Investment in Real Property Tax Act of 1980 [FIRPTA] in a moment.

B. New and Proposed Legislation

The other broad area I want to touch on briefly is new legislation designed to make the playing field even: in particular, two recently enacted pieces and one proposed piece of legislation. I will limit my remarks on the first: the International Banking Act of 1978 [IBA] about which you have heard a great deal. Let me underscore the previous comment that in enacting the IBA the Congress passed up the opportunity to be pro-competitive by eliminating artificial restrictions imposed on domestic institutions in this country. Instead, a second dual banking system was created where one is difficult enough to understand.

(i) Banking

Prior to enactment of the IBA, the vagaries of our bank regulatory system, with separate federal and state bank regulators, presented opportunities to foreign banks operating in the U.S. that were not available to their domestic counterparts. In particular, foreign banks could establish branches or agencies in as many states as permitted such entry and could establish securities affiliates here. Similar activities were not available to U.S. banks because of the McFadden Act and the Glass-Steagall Act. The IBA redressed this imbalance by imposing similar limitations on foreign bank activity here while creating a separate dual banking system for foreign banks, which as a result may now establish either federal or state branches or agencies. Although the IBA fashioned a politically acceptable compromise to some issues surrounding foreign investment in the domestic banking system, controversy continues to rage concerning foreign acquisitions of U.S. banks and even--as has so often been the case with banking regulation in this country--about the scope of authority of federal regulators in granting branch licenses to foreign banks in states with more restrictive legislation, regulation, or lore than appears to be consistent with such licensing on the federal level. A three-month moratorium on the approval by federal bank regulators of applications in connection with takeovers of U.S. banks by foreign persons was enacted as part of the Depository Instituions Deregulation and Monetary Control Act of 1980.

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(ii) Real estate

In the tax and real estate areas, and in response to the dictates of the Revenue Act of 1978, the Treasury Department completed a study of the federal tax treatment of income from, and gains on the sale of, interests in U.S. property held by non-resident aliens and foreign corporations. The study concluded that such persons, unlike their domestic counterparts, rarely incurred capital gains tax on disposition of their U.S. properties because of various techniques designed to change such property from being "effectively connected" with a U.S. trade or business to not being so connected. Such devices converted capital gains on real estate, which were ordinarily taxable, into gains on other assets which were not. To rectify this apparent inequity, FIRPTA was enacted in the closing days of the 96th Congress. FIRPTA generally provides that any gain or loss realized by a foreign person from the disposition of U.S. real property will be taxed as "effectively connected" with a U.S. trade or business. FIRPTA also imposes significant reporting requirements as to foreign beneficial owners of non-public U.S. companies, which may be avoided if adequate security for tax collections is provided. Congressional efforts to impose a withholding tax on gains from the disposition of U.S. real estate were unsuccessful.

(iii) Margin requirements

Legislation has been proposed in the 97th Congress to extend the application of margin regulations to stock acquisitions by foreign entities that are not controlled by U.S. persons. Section 7 of the Securities Act of 1934 does not at present authorize this extension, presumably because of concern over the jurisdictional reach of our laws. Currently, only domestic borrowers and most domestic lenders are subject to Federal Reserve Board Regulations G, T, U and/or X imposing generally a fifty percent margin requirement on secured loans, the proceeds of which are to be used to purchase stock. Accordingly, a foreign borrower may borrow from a foreign lender to make a U.S. acquisition without the imposition of margin requirements. The difficulties of national regulation of an increasingly international capital market exemplified in this instance were perhaps even more strikingly presented during much of 1980, when the Federal Reserve Board attempted through its powers of "moral suasion" over domestic banks to allocate credit away from so-called non-productive uses, such as the acquisition of existing business enterprises. The Board's persuasive powers were, of course, less powerfully employed against foreign lenders.

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APPENDIX X

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RESTRICTIONS ON FOREIGN INVESTMENT: DEVELOPMENTS IN EUROPEAN LAW

André Bruyneel*

MR. HAWES: Now, we would like to hear where Europe--if one may unitize the term in this fashion (and I am sure one may not)--where Europe fits on the spectrum of neutrality or antagonism or welcoming of foreign investment.

1. INTRODUCTION

MR. BRUYNEEL: It is rather awkward, for various reasons, to treat this topic. First, under the label "European Law" are included not only international and EEC regulations but also about twenty national legal systems from Iceland to Turkey--even after leaving out East European countries. The documentation we have collected--though, of course, incomplete--stands three feet high, while only twenty minutes have been provided for my address.

Second, the topic is but partly a matter of law; for example, authors rarely comment on the administrative remedies available against a decision to refuse an authorization. Basically, the rules depend on economic policy. Moreover, the sources of the law are relatively difficult to use. These are either statutory provisions --frequently complicated and poorly drafted--that are far from the actual administrative practice [1], or they are descriptions, such as the OECD documents, prepared on the basis of inquiries made exclusively to national administrations [2].

Third, numerous factors that are unrelated to the usual notion of restrictions on foreign investment influence a decision to invest abroad. Some of these factors may have a significant restrictive effect, for example, tax treatment of branches, antitrust law [3], possible obligation to launch a public offer after acquiring control of a company [4], intensity of labor involvement in takeovers and mergers [5], and similar considerations. Thus, it is essential not to go astray, despite the appeal of such side issues.

The final difficulty is that the topic seems somewhat paradoxical in a period when the general trend in Europe is characterized by some withdrawal of foreign branches and subsidiaries. Because of this curtailment and, more particularly, in order to

*It is my privilege to thank Mr. Marc Kadaner, member of the Brussels Bar and teaching fellow at Brussels University, for his helpful assistance in collecting a major part of the documentation. I also would like to thank the numerous persons (professors, attorneys, civil servants, central bank or bank officials, etc.) who kindly agreed to answer my questions on their respective national laws and administrative practices.

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stabilize employment, there is serious competition for systematically attracting and retaining foreign investment--not for setting up new restrictions [6]. Rather low stock price quotations (which can stimulate takeovers under good financial conditions), together with massive public grants and various other factors, explain the persistence of an important though reduced flow of foreign investment in Europe [7].

I shall try to meet the challenge of my topic, however, by immediately making clear three limits on my discussion. I shall consider only (1) significant and direct restrictions on foreign direct investment--thus investments abroad and portfolio investments will be excluded; (2) general rules--thus restrictions specific to any particular economic sector, with the exception of banking, will be disregarded; (3) the most prevalent restrictions--because it would be difficult and tedious to describe the regulations existing in about twenty different countries. I shall endeavor to sketch, on the basis of some examples, the main types of investment restrictions before trying to evaluate their development and effectiveness. Prior examination of some international and EEC aspects will be necessary.

2. INTERNATIONAL AND EEC INFLUENCES

EEC law must, of course, be given precedence. However, it is useful first to have a look at certain rules established by the OECD to create a more traditional--and less explicit--framework for international cooperation.

A. OECD Rules

Since 1961, the Member States (except Canada) have adopted the OECD Code of Liberalization of Capital Movements [8]. According to articles 1 and 2, the contracting parties commit themselves to automatic authorization of transactions related to direct investments in or from other OECD countries (these transactions are included in OECD lists A/I/A and B). This rule of liberalization allows Member States to declare reservations or national abrogations, although these are rare as regards foreign direct investment. Here we find the justification for a periodic examination and review of the current situation by the Committee of Invisible Transactions and Capital Movements. National practices have consequently become more open to public view, and they are the bases of an interesting documentation kept up-to-date and published by the OECD [9].

In addition to the Code on Capital Movements, the Declaration on International Investment and Multinational Enterprises was issued by the governments of OECD Member States on June 21, 1976 [10]. The principal contents of the Declaration are (1) a recommendation that multinational enterprises observe the Guidelines for Multinational Enterprises [11]; (2) a rather general statement on international investment incentives and disincentives, together with a consultation procedure (which is never applied) in case of difficulties; and (3) an endorsement of the principle of national treatment, to be granted to foreign-controlled enterprises by each Member State.

Information concerning the application of this last principle --in fields like taxation, governmental grants, access to bank credits and financial markets, procurement contracts, and manufacturing licenses--has been periodically published [12] and illustrates the

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

not infrequent reluctance of national authorities to answer OECD inquiries with clarity and completeness.

B. EEC Law

With the law of the European Communities, we enter a field with much greater constraints on the national governments. Article 3(c) of the EEC Treaty provides for "the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital," and this general principle is implemented in title III of the Treaty. The free movement of goods is, of course, the fourth fundamental EEC freedom [13]. I shall now comment only on "freedom of establishment" and on "freedom of capital movements." [14]

(i) Freedom of establishment

(In fact, this means equal treatment, rather than a blanket right of establishment.)

According to article 52, paragraph 1, "restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be abolished by progressive stages in the course of the transitional period." The restraints to be abolished include "restrictions on the setting up of agencies, branches or subsidiaries" and restrictions on the right "to set up and manage undertakings, in particular companies or firms." [15]

Article 52 was completed by the standstill clause of article 53, which prohibited the imposition of new restrictions, and by the very important article 54, which established procedures and time limits for the abolition of existing restrictions, assigned special duties to the Council and the Commission [16], and authorized coordination provisions [17].

According to the case law of the European Court of Justice [18], the articles of the Treaty concerning all the freedoms--except free movement of capital--are directly applicable to Member States since the end of the transitional period: January 1, 1970. This means that all restrictions are automatically abolished without need for further directives. Furthermore, these articles of the Treaty have created rights that may be enforced in court by individuals or companies against Member States, other individuals, or corporations [19] [20].

Except for capital-movement problems, hereafter discussed, more restrictions on foreign investments among EEC countries have been abolished as a result of application of the right of establishment or of the Commission's pressure.

One Belgian example is worth noting. In order to protect Belgian enterprises against foreign takeovers in conflict with national policy, the Act on Stock Exchanges was modified in 1967 to require an authorization by the Minister of Finance in any case of a public takeover bid launched by or on behalf of foreigners or Belgian companies under direct or indirect foreign control [21]. On the basis of the right of establishment and the standstill clause, the EEC Commission soon required the abolition of this new provision [22]. The Commission, clearly intending to make an example, rejected all defenses presented by the Belgian government [23] and threatened to bring the case before the Court of Justice in Luxembourg [24].

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Finally, the law was changed in 1972, and the authorization system was restricted to public takeover bids launched by non-EEC foreigners [25]. After 1972--and before then as well--cases of refusal of authorization were extremely rare [26] [27] [28]. Today, the Commission is still active in its role of watchdog for the freedom of establishment. For example, it takes action against Member States when it discovers bylaws of important industrial companies or banks that prevent foreigners from becoming shareholders.

(ii) Free movement of capital

The unrestricted movement of capital involves a difficult freedom. It is very closely linked to internal financial markets and to their control--thus implicating economic policies that the Treaty has basically left to the Member States. Articles 104 to 109 on the balance of payments [29] illustrate the necessary equilibrium between the free movement of capital and the needs of national economic policies. These provisions, together with articles 67 to 73 on the free movement of capital [30], have created a situation which is complex and not uniform in all Member States.

According to article 106, paragraph 1, "each Member State undertakes to authorize any payments connected with the movement of goods, services or capital, and any transfers of capital . . . *to the extent* that the movement of goods, services, capital and persons between Member States has been liberalized pursuant to this Treaty." [emphasis added]. Article 106 has thus automatically freed nearly all current payments connected with the basic freedoms: the movement of goods, workers, and services; and the right of establishment.

The situation is different for capital movements because article 67 is not directly binding on Member States [31]. However, two directives of 1960 and 1962 [32] have eased restrictions on many foreign exchange transactions, but to an extent that differs according to four categories of transactions. For the first category (list A of Annex I), transactions between EEC residents are unconditionally freed; and the transactions of list A include direct investments and real estate investments. [33]

Unfortunately for the principle of free movement and for list A, in the Treaty there are also three safeguard clauses. Article 108 provides for Community response to difficulties in one Member State as regards balance of payments; article 109 allows national action in case of a sudden crisis in the balance of payments; and article 73 deals with disturbances in the functioning of the capital market.

The EEC achievements in the field of capital movements can hardly be considered satisfactory. The situation differs from one Member State to another, because list C includes only certain countries and because of the use of safeguard clauses in favor of France, the U.K., Ireland, Denmark,and Italy [34]. Even for liberated transactions, nothing has been done to reduce formalities, paperwork, and stamps [35]. And, finally, the Commission did not succeed with its 1964 proposal for a third directive in the field of capital movements [36].

At this moment, I should like to tell you an interesting French story that demonstrates perfectly the vicious interaction that is possible between exchange control objectives and the regulation of foreign direct investments.

In 1967, exchange control was abolished in France, but at the same time a system for controlling foreign investments was set up.

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Prior notification was required and the Minister of the Economy retained a right of refusal (*droit d'ajournement*) for two months after notification [37]. Then, for political reasons, France was obliged to reinstitute exchange controls, first in May 1968 and then on November 24, 1968. These measures were *a posteriori* legalized at the EEC level--on the basis of the article 108 safeguard clause [38] --and they still remain in force.

However, the EEC Commission refused to accept the *droit d'ajournement* as far as control of foreign direct investment was concerned. An action was initiated in 1969 against France, for (obvious, in my opinion) violation of article 52 freedom of establishment [39]. Finally, in 1971, the French government agreed to cancel the *droit d'ajournement*; but, at the same time the exchange control regulations were completed by the addition of an authorization procedure for foreign direct investments [40].

As you can imagine, this authorization procedure was not infrequently used for purposes other than exchange control. There were a number of cases of denial or failure to answer--which takes longer for the applicant but has the legal effect of a refusal. Some of these cases are well-known (like the Ferodo case) and have created new difficulties between Paris and Brussels: in effect, this authorization system, as applied, was contrary to the right of establishment and was also a misuse of the exceptional safeguard measures granted to France in 1968 in the field of exchange control only.

The (perhaps temporary) end of the story came with the very important Decree of August 4, 1980 [41], which has replaced--but only for direct investments inside the EEC--the authorization system by a mere notification that is supposed to be exclusively for statistical purposes [42].

3. RESTRICTIONS ON FOREIGN DIRECT INVESTMENTS

I would be going beyond my topic if I were to draft a catalogue of all existing restrictions [43]. But it seems worthwhile to reduce my three-foot-high documentation to a short list of the main types of restraints that I have discovered. These are the most common restrictions: (1) exchange control restrictions, legitimate or misused, for the purpose of controlling foreign investments (*e.g.*, Ireland, Italy, U.K. before 1979) [44]; (2) monetary policy measures prohibiting any acquisition of national securities (*e.g.*, Switzerland in 1978-1979) [45]; (3) restrictions on acquisition of land and buildings (*e.g.*, Finland, Switzerland since 1961) [46].

As far as takeovers and the establishment of branches and subsidiaries are concerned, these requirements are frequently encountered: (4) discretionary authorization--that is, the power to prohibit (*e.g.*, France for non-EEC investments, U.K., Spain, Norway, Portugal) [47]; (5) special discretionary authorization in the field of public takeover bids (*e.g.*, Belgium for non-EEC investments) [48]; (6) prior notification for reasons of industrial policy (*e.g.*, Belgium) [49]; (7) notification for statistical purposes--prior, subsequent, or periodic (*e.g.*, France for EEC investments, Germany) [50]; (9) business permit for setting up a branch (*e.g.*, Germany for non-EEC investments, Spain) [51].

One could also mention a variety of other regulatory mandates:

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special permits (industrial, regional, pollution) [52], foreign joint venture laws in Eastern Europe [53], compulsory residence for the manager of a branch [54], residence, work, and foreign merchant permits [55], consultation with professional councils [56], requirements applicable to transfer-of-technology agreements [57], and rules for specific economic sectors such as national defense, transportation, energy, nuclear industry, pharmaceutical industry, agriculture, insurance companies, and banks [58].

That is not all, because restrictions can also be found in corporate law, specifying the nationality of founders [59], shareholders [60], directors [61] or managers [62]. Less significant, of course, are provisions requiring the mention of foreign directors on the letterhead of the company [63] or the compulsory reporting to the company of any shareholding in excess of twenty-five percent [64].

Finally, purely private restrictions in company bylaws should be mentioned as prohibitions against foreign shareholding [65]. For example, the Swiss practice of *titres nominatifs liés* [66] grants the board of directors the discretionary power to refuse new shareholders. Thus, it is extremely difficult to achieve a successful takeover against the wish of the board. In the field of private restrictions, comment could also be added about U.K. situations (or, more exactly, City situations) such as membership in Lloyd's [67] or the membership of the Accepting Houses Committee [68].

4. DEVELOPMENT AND EFFECTIVENESS OF RESTRICTIONS

I do not want to leave you, after such a catalogue, with the misleading impression that European thinking is basically hostile to a liberal or neutral approach to the movement of capital. Some very brief comments on recent developments and on the effectiveness of restrictions may help you to understand where we really stand on the other side of the Atlantic.

A. Developments

The only recent developments that can be considered very significant are the 1979 abolition of exchange control in Great Britain and the 1980 liberalization in France, mainly for EEC investments. In the long run, the principal trend is certainly toward the reduction--in law and in fact--of existing restrictions. As far as EEC countries are concerned, this trend has been stimulated by EEC law on the right of establishment. Often in Member States, the abolition of one or another restriction for EEC investments was extended to all foreign investments.

However, there is also a trend in the other direction, linked to the development of more interventionist industrial and regional policies in several countries. The application of such policies rarely remains completely neutral with regard to equal treatment of foreign investments.

B. Effectiveness

First of all, it should be kept in mind that many authorization or prohibition devices--although very impressive as statutory or regulatory texts--are never or very rarely applied [69].

Second, it should be noted that the effectiveness of statu-

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tory authorization or prohibition devices is not altogether evident. Certainly, the private Swiss device of *titres nominatifs liés* has played a protective role for Swiss corporations that is much more efficient than any governmental control of foreign direct investments [70].

Another example of the circumvention of official regulation may be found in France. In November 1980--thanks to the abolition of the authorization procedure for EEC investments--the Italian group Ferruzzi took control of Beghin-Say, the number one French sugar company. One month later, because of extremely heavy pressures from the President, the French government, and French agricultural circles, a "French solution" was found in agreement with Ferruzzi [71]. The Italian group had properly read the Circular of 1980, but apparently it forgot that the agriculture and food sector had become private turf for the French.

Other examples of "national solutions" may be found in the British or the German practice of takeovers [72], which are controlled without the assistance of restrictive regulations.

Finally, with all their complicated regulations, are the European governments better equipped than the British Foreign Office was in 1890 when it simply said "no" to shareholders who were intending to sell a controlling interest in the North-West Africa Company to Leopold II, as King of the Congo [73]? I leave the answer to each of you, and I come to the last topic: restrictions on foreign direct investment in the field of banking.

5. RESTRICTIONS ON FOREIGN INVESTMENT IN BANKS

First, let me point out that up to now neither the EEC nor any individual European country has established a corpus of national and international banking regulations as complicated as that of the U.S. (and I hope it will never happen). Even for a specialist, U.S. rules can be reasonably characterized as a legal nightmare [74]. Before ending with some examples of restrictions in non-EEC countries, I shall consider foreign investments in EEC banks.

A. Within the EEC

The right-of-establishment principles which were discussed earlier with regard to corporations [75] are also applicable to the banking sector of the EEC. However, in a business that has traditionally been protected and closely supervised, liberalization is not so easy. As a matter of fact, right-of-establishment problems in banking are entangled with problems of freedom to render services [76] and problems of capital movements [77]. From the point of view of the EEC Treaty, most of the principal banking operations--such as granting credit, accepting deposits, issuing bonds, buying and selling securities--are not services but are movements of capital. Therefore, they are not yet fully liberated. Moreover, national supervisory systems are usually based on the site of establishment [78].

Although this situation has not prevented achievements such as the merger of the London and Dublin Stock Exchanges, the movement of German banks to Luxembourg, or various examples of cooperation between European banks in the seventies, it can be improved only by means of the coordination procedures established by the EEC Treaty [79].

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In the banking field [80] two directives have been adopted. The first one is the "Council directive of 28 June 1978 [81] on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions." The second directive is the "(first) Council directive of 12 December 1977 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions" [82].

The present situation, resulting from the two directives and their implementation [83], can be summed up in three comments. (1) As regards the right of establishment, there are no longer any significant restrictions on the formation in EEC Member States of branches or subsidiaries of EEC credit institutions [84]. (2) There remain, however, transitional difficulties to be solved concerning the standard "economic needs of the market" and its application [85]. (3) Article 9 of the 1977 Directive deals with branches of credit institutions whose head offices lie outside the Community [86]. On the one hand, Member States may not apply a more favorable treatment than the EEC treatment to such branches; on the other hand, the Community may, through agreements with third countries on the basis of reciprocity, accord to such branches identical treatment throughout the EEC territory.

Presently no agreement of this kind exists, but it may be said that the EEC freedom of establishment and the implementation of banking directives have generally encouraged equal treatment of branches and subsidiaries of EEC and non-EEC credit institutions. This is perfectly illustrated by the U.K. Banking Act of 1979 which made no distinction between EEC and non-EEC foreign banks [87].

As a matter of fact, current legal and practical banking issues primarily concern supervision, and cooperation between supervisory authorities [88], rather than restrictions on foreign investments in banks. The stronger the cooperation grows, the less important will be the need for restrictions.

B. Restrictions in Non-EEC Countries

Restrictions on foreign investment in banks still exist, however, inside the EEC--for non-EEC investors--as well as outside the EEC--for all investors. In this second category, Switzerland and Spain are two examples of countries with special treatment of foreign banks.

The Swiss situation is typical. The multiplication of foreign bank subsidiaries in Switzerland during the sixties led to the introduction, in 1971 of special rules concerning "banks in foreign hands" [89]. This statutory regime controlling foreign banking subsidiaries [90] was built on the basis of two principles: (1) The granting of a bank licence is subject to the traditional condition of reciprocity [91]. (2) Precautions must be taken to prevent the subsidiary from giving the impression, because of its name, that it is a Swiss bank. Rules are also designed to ensure a significant allegiance to Switzerland in matters such as monetary and credit policies, the residence of managers, and representation of the subsidiary [92].

The application of such rules turned out--not surprisingly--to be difficult. There is no clear standard defining a bank in foreign hands (let us think of the example of a Swiss bank with forty-five percent foreign shareholding), or the condition of

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

reciprocity, which the Federal Banking Commission identifies through a flexible, case-by-case approach [93].

The Spanish banking law, which had been extraordinarily restrictive toward foreign investment, was substantially liberalized by a Royal Decree in 1978 [94] in accordance with the Spanish open-door policy after Franco. The classical standard of reciprocity was chosen, together with a discretionary authorization--based on national economic interest--to be granted by the Council of Ministers itself.

Apparently no European country presently has a provision like the one contained in the Canadian Bank Act of 1967 which, until 1980, required seventy-five percent Canadian control of all federally chartered banks [95]. Furthermore, there is nothing comparable to the provision of the Canadian Bank Act of 1980, restricting the domestic assets of all foreign bank subsidiaries in the aggregate to eight percent of total domestic assets of all banks in Canada[96].

MR. HAWES: Thank you, André. Assume that a client comes to you wanting to make a direct investment--not a takeover bid, but just to establish a subsidiary or to buy property. Take Belgium, if you wish, and let us say it is an American company or investor. Would your approach be to say, "It is quite possible," or "It is going to be very, very difficult"? Where does it fit in that spectrum?

MR. BRUYNEEL: No doubt I would answer, "It will be easy, as far as Belgium is concerned."

MR. HAWES: If you were a French lawyer or a German lawyer?

MR. BRUYNEEL: I would say, "Be very, very, very careful."

NOTES

[1] Sometimes there are very restrictive legal provisions that are never applied (*e.g.*, article 13 of the U.K. 1975 Industry Act), or there may be restrictive administrative practices developed with or without a basis in statutory law.

[2] *See particularly*, *International Direct Investment* (policies, procedures, and practices in OECD member countries), OECD publications, 1979.

[3] *E.g.*, as far as EEC antitrust law is concerned, substantial difficulties can arise with some types of joint ventures. *See* Lukoff, *Joint Ventures, EEC Theory and Developing Case Law*, 2 The International Contract 37-44 (1981). In connection with Article 86 of the Treaty, *see* the Continental Can case: Judgment of 21 February 1973, [1973] ECR 215.

[4] *See, e.g.*, General principle nr. 13 of the City Code on Take-overs and Mergers (revised edition February 1981). An excellent comparative study on the sale of controlling interest is Lempereur, *Cessions de majorité et protection des actionnaires minoritaires en droit comparé*, 1978 Revue Pratique des Sociétés (Brussels) 91-187.

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[5] *E.g.*, such involvement is very important in the Netherlands with respect to acquisitions (*see* Act on Workers' Councils, as amended September 1, 1979) or public takeover bids and mergers (*see* Fusiegedragsregelscode 1975, which is a resolution of the Social and Economic Council).

[6] The trend will probably and unfortunately be very different in the field of trade policies, at least for several sensitive sectors.

[7] For a description of the general trends, *see* the OECD documents published from time to time by the Committee on International Investment and Multinational Enterprises.

[8] The most recent edition was published in 1978 by OECD publications. The original 1961 Code was adopted after promulgation of the OECD Code of Liberalization of Current Invisible Transactions. As regards current payments, *compare* the IMF rules and the 1955 European Monetary Agreement.

[9] *International Direct Investment, supra* note 2. This document shows, *inter alia,* that national authorities do not always fully respond to questions; that every government considers its practice to be liberal; that exchange control is, as far as foreign investment is concerned, a basically ambiguous matter; and that national statistics are extremely difficult to compare--for example, the number of refused authorizations or number of applications withdrawn.

[10] *International Investment and Multinational Enterprises,* OECD publications, ed. 1979. (1976 Declaration and Council's Decisions.)

[11] For a well-known application of this non-binding set of rules, *see* the Badger case (1977): Blanpain, The Badger Case and the OECD Guidelines for Multinational Enterprises (Kluwer, 1977).

[12] *National Treatment for Foreign-Controlled Enterprises,* OECD publications, 1978; *International Investment and Multinational Enterprises, supra* note 10.

[13] EEC Treaty, title I.

[14] The freedom of movement for workers (articles 48 and 51) and the freedom to provide services (articles 59 to 66) within the Community do not involve, at least directly, restrictions on foreign investment. For a detailed description of EEC law on the four freedoms, *see* Mégret and others, Le droit de la Communauté économique européenne, volume 3 (Brussels, 1971).

[15] Article 52 refers to the article 58 meaning of companies or firms and to chapter 4 provisions on the free movement of capital. EEC Treaty. The problem of dominion is therefore solved without reference to a theory of control.

[16] *See* article 54, para. 3(e)(f) and (h), EEC Treaty.

[17] Article 54, para. 3(g), pertaining to companies, and article 57, para. 2 concerning the financial sector, EEC Treaty.

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

[18] Reyners case: Judgment of 21 June 1974, case 21/74 [1974] ECR 631; Van Binsbergen case: Judgment of 3 December 1974, case 33/74 [1974] ECR 1299; and several subsequent cases aimed at clarifying points of detail.

[19] The application of these principles concerning the right of establishment was in no respect modified or delayed by the Accession Treaty of 1972 (Denmark, Ireland, and U.K.) or by the Accession Treaty of 1979 (Greece).

[20] On the fundamental question of the "direct effect" of EEC Treaty provisions, *see* Lecourt, L'Europe des juges 248-263 (Brussels, 1979). Concerning the less direct effect of EEC directives, *see* Pescatore, L'effet des directives communautaires: une tentative de démythification, chron. XXV (Dalloz Sirey, 1980) (only the lack of implementation, or inadequate implementation, of a directive may be brought as a cause of action, and only against a Member State); *see also*, Timmermans, *Directives: Their Effect Within the National Legal Systems*, 1979 Common Market Law Review 533-555.

[21] Commercial Code, book I, title V, article 108, §2; *see Report to the King*, Pasinomie 1967, 1313-1314, pertaining to the traditionally liberal attitude of the Belgian government and to the OECD Code of 1961.

[22] In addition, the Commission was not pleased by the standard "company under foreign control"--even as elucidated by the "general programmes" of 18 December 1961: "lien effectif et continu avec l'économie d'un Etat membre".

[23] A declaration that article 108, §2 would never be applied to EEC nationals, except after the procedure established by article 73 of the EEC Treaty; the claim that enterprises in a small country are particularly exposed to foreign takeovers; and other arguments. *See* the legislative history of the Act of 1972, *infra* note 25.

[24] EEC Treaty, article 169.

[25] Act of 11 July 1972, Pasinomie 1972, 418-426, including the legislative history and a description of similar restrictions in other EEC countries. The new text of article 108, §2 is worded as follows:

> The same authorization shall be required for any public offer to exchange or to purchase Belgian securities, realized by or for the account of:
> 1. physical persons other than nationals of a member state of the European Economic Community;
> 2. corporate bodies, public or private, that are not formed according to the law of one of these states;
> 3. corporate bodies, public or private, that are formed according to the law of one of these states but that do not have their registered office, administration office or principal place of business within the Community.

[26] An interesting case happened in the insurance field. The Minister of Finance rejected a U.K. public takeover bid for a Belgian insurance company because the bidder, unlike another bidder, did not undertake to maintain full employment in the Belgian company.

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[27] Public takeover bids are under the supervision of the Banking Commission, which acts in order to protect investors, not in order to evaluate the takeover. On that supervision, *see* Bruyneel, *The Belgian Commission Bancaire: Functions and Methods,* 1980 DPCI 351-384 (up-to-date revision of an article published in the Journal of Comparative Corporate Law and Securities Regulation, 1 J. Comp. Corp. L. & Sec. Reg. 187 (1978)).

[28] The Belgian government was also compelled to propose to Parliament a modification of article 36 of the Act of 30 December 1970 on economic expansion, which deals with incentives, grants, employment, planning, and measures of industrial policy. Article 36 requires prior notification to the Minister of Economic Affairs, the Minister of Finance, and the Minister of Regional Economic Affairs in case of sale to foreigners--or Belgian companies under direct or indirect foreign control--of more than one third of the capital of a Belgian enterprise with an equity of at least BF 100 million. The solution finally adopted (Act of 17 August 1973) was not to lift the restriction for EEC investors as with article 108; but instead, the prior notification system was extended to all sales, even to Belgian nationals.

[29] Chapter 2 of title II of the EEC Treaty.

[30] Article 67: principle; articles 68 and 69: program, procedure, and directives; articles 70 and 72: coordination of the exchange policies towards third countries; article 71: standstill clause; article 70, para. 2 and article 73: safeguard clauses. *See also* article 221: national treatment respecting participation in the capital of companies or firms.

The consistency and combination of the two sets of rules (67 to 73; 104 to 109) is a difficult matter: *see* Mégret *et al., supra* note 14, volume 3, at 173-259; Heenen, *La libre circulation des capitaux,* in Novelles, Droit des Communautés européennes 755-772 (Brussels, 1969).

On escape clauses, *see* Manin, *A propos des clauses de sauvegarde,* 1970 Rev. trim. dr. eur. 1-42; Seidel, *Escape Clauses in European Community Law,* 1978 Common Market Law Review 283-308 (with special reference to capital movements).

[31] Mégret *et al., supra* note 14, volume 3, at 177. The European Court of Justice will soon deal with this problem.

[32] First directive of 11 May 1960 (JOCE nr. 43 of 12 July 1960); second directive of 18 December 1962 (JOCE nr. 9 of 22 January 1963).

[33] *Compare* list B, where transactions such as portfolio investments in quoted securities are unconditionally made free on the basis of general exchange authorizations; list C, where transactions are conditionally made free—*i.e.,* only in Member States (Germany, Belgium, Luxembourg) where such freedom already existed in 1960; and list D, where transactions that might involve speculative capital movements are not necessarily freed by the Member States. The four lists were based on the corresponding liberalization work of the OECD Code of 1961.

[34] *See also* article 49 ff, 1979 Accession Treaty with Greece.

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

[35] For example, it must be determined whether a transaction is to be found on list A or on another list. The same odd practice exists in systems of two-tier exchange markets--as in Belgium.

[36] *See* Mégret *et al.*, *supra* note 14, volume 3, at 210-215. The EEC's rather minimal achievement in the field of capital movements can be explained by various factors: treaty objectives are less precise than for the other freedoms; there is a lack of clarity and consistency between articles 67 to 73 and articles 104 to 109; political will was weak and there was no precise conception of an ideal European capital market. This situation led to the "Rapport Segré": *Le développement d'un marché européen des capitaux,* EEC publication nr. 8.181 (1966) which is at the origin of EEC efforts in other directions: *inter alia*, coordination in the banking field, securities markets, and economic and monetary union. *See* Mégret *et al.*, *supra* note 14, volume 6 at 29-134.

[37] Decree nr. 67-78 of 27 January 1967 and subsequent decrees and circulars issued according to Act nr. 66-1008 of 28 December 1966.

[38] Decree nr. 68-1021 of 24 November 1968 issued according to Act No. 66-1008, *id.* EEC decisions of 23 July 1968 (JOCE nr. L 178 of 25 July 1968) and of 4 December 1968 (JOCE nr. L 295 of 7 December 1968). The validity of the application of articles 108 and 109 of the EEC Treaty has been contested, but not successfully. *See* Judgment of 2 February 1976, Tribunal de grande instance de Lille, Dalloz Sirey [1979] jur. 241-245, note Minet.

[39] Appeal nr. 66/69 filed, but never heard, at the European Court of Justice. *See* Mégret *et al.*, *supra* note 14, volume 3 at 218-228; *see also* the EEC answer to a parliamentary question in 1969: 1970 Rev. trim. dr. eur. 183-184 (which refers to articles 52-58 (and directives), article 221, and article 67 (and 1960 directives)).

[40] Decree nr. 71-144 of 22 February 1971 replacing article 4 of Decree nr. 68-1021, *supra* note 38; *see also* Decree nr. 74-721 of 26 July 1974, introducing a new article 4 bis in Decree nr. 68-1021.

[41] Journal officiel of 5 August 1980. Article 4 bis of Decree nr. 68-1021 is now worded as follows:

> 1° Les investissements directs effectués à l'intérieur de la Communauté économique européenne qui répondent aux deux conditions suivantes *sont libres*

with three exceptions:

> Les investissements effectués dans des activités participant en France, même à titre occasionnel, à l'exercice de l'autorité publique; les investissements mettant en cause l'ordre public ou la santé publique ou la sécurité publique, ainsi que ceux réalisés dans des activités de production ou de commerce d'armes, de munitions et de matériels de guerre; les opérations ayant pour effect de faire échec à l'application des lois et réglementations françaises.

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[42] On the basis of the Decree of 4 August 1980, there has been published a very comprehensive new *Circular of 6 August 1980*, Journal officiel of 9 August 1980. The Circular is interesting in many respects: it gives a detailed and extensive definition of control; it excludes EEC companies under foreign control; and it contains other measures liberalizing small-sized foreign direct investments in France.

[43] Attempts to draft such a catalogue were made in the two OECD documents referred to in notes 9 and 12 *supra*. Other interesting sources include a booklet published by Abecor in 1976: *Investissements étrangers en Europe;* the *Tax Management* series; and booklets published for each country (*Investment in ...)* by firms like Peat, Marwick, Mitchell & Co.

Such introductory sources must be complemented by an examination of the legal texts and also by meetings designed to provide a satisfactory understanding of administrative practices. I had such contacts in several countries but, due to lack of time, I cannot comment on the various interesting discoveries I made and the conclusions that can be drawn.

[44] Also problems of repatriation of income or investment. The misuse of exchange control is particularly clear when the control was established in order to avoid excessive outflow of capital.

[45] The abolition of the Federal Council Decree on investment by non-residents in Swiss securities became effective on 24 January 1979.

[46] "Lex Furgler": Decree of the Federal Assembly of 23 March 1961; Federal Council Decree of 21 December 1973. The system, which is presently under review, has apparently never been used to prevent a subsidiary or a branch from buying land and buildings necessary for its industrial activity.

[47] France: *see* section 2B(ii) *supra* at 144 and notes 37 to 42. U.K.: *see* article 13 of the 1975 Industry Act concerning change of control contrary to the interests of the U.K. or any substantial part thereof. Spain: *see* Decrees of 31 October 1974 and Royal Decree of 26 November 1976, pertaining to foreign direct investment in excess of 50% of the capital of a Spanish company. Norway: *see International Direct Investment, supra* note 2. Portugal: *see* Foreign Investment Code: Decree-Act nr. 348/77.

[48] Article 108, paragraph 2 of the Act on stock exchanges. *See* section 2B(i) *supra* at 143 and notes 25 to 27.

[49] Article 36 of the Act of 30 December 1970: *see supra* note 28.

[50] France: *see* section 2B(ii) *supra* at 144 and notes 37 to 42. Germany: *see* Aussenwirtschaftsgesetz (AWG), §1.

[51] Germany: *see* Gewerbeordnung (GewO), §12. The permit may be refused for lack of reciprocity. Spain: authorization of the Ministry of Commerce: *see* Decree of 31 October 1974 articles 13-14.

[52] *E.g.,* in the Netherlands.

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

[53] *E.g.*, in Yugoslavia, *see* the Act of 30 March 1978 on foreign investments (comprehensive commentary in 1980 DPCI 385-415). *See* in general, Florescu, *Les sociétés mixtes dans les pays socialistes, nouvelle forme de coopération économique internationale*, 1978 DPCI 243-267.

[54] Frequently required by tax regulations.

[55] In all countries, except for EEC nationals in Member States. A particularly restrictive policy in this respect has been followed by Switzerland for several years; *see* Revaclier, *Obstacles à l'implantation d'entreprises étrangères en Suisse: les dispositions limitant le nombre des étrangers qui exercent une activité lucrative*, 1976 DPCI 89-99.

[56] *E.g.*, in Austria.

[57] *E.g.*, in Spain.

[58] As far as banks are concerned, *see* section 5 *infra* at 147.

[59] *E.g.*, in Denmark at least two founders must be Danish (Company Act, article 11 for A/S), but this requirement has been lifted for EEC nationals.

[60] *E.g.*, in Finland the bylaws may limit foreign shareholdings to 20% of the capital: *International Direct Investment*, *supra* note 2, at 23.

[61] *E.g.*, in Denmark at least half of the directors must be Danish (Company Act, article 52 for A/S), but this requirement has been lifted for EEC nationals. In Switzerland a majority of the directors of an S.A. must be Swiss nationals residing in Switzerland, with a possibility of exemption for holding companies (Code des obligations, art. 711, para.2).

[62] *E.g.*, in Denmark (Company Act, article 52 for A/S), but this requirement has been lifted for EEC nationals.

[63] U.K. Company Act of 1948, article 201. This requirement has been lifted for EEC nationals.

[64] German Aktiengesetz, article 20. The company is in turn obliged to publish any information it receives on such shareholding in excess of 25 percent.

[65] *See* section 2B(i) *supra* at 143 for the position of EEC nationals.

[66] Stimulated by the Federal Council as far as banks are concerned.

[67] However, Lloyd's has had foreign "names" since 1968.

[68] Anthony Gibbs, after becoming a subsidiary of the Hong Kong and Shanghai Bank, withdrew from the Committee.

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[69] *E.g.*, article 13 of the U.K. 1975 Industry Act has never been applied; also it apparently was never communicated to the OECD. *See* Weinberg, On Take-over and Mergers (nr. 1505, 1979 ed.). In Belgium, article 108, para. 2 of the Act on stock exchanges, *supra* note 48, has been applied only extremely rarely. *See also* the statistical data published in *International Direct Investment, supra* note 2. It should be noted, however, that the length of the authorization procedure has sometimes in fact resulted in the prevention of an investment.

[70] Compare, for example, the rather minor importance of branches and subsidiaries of multinational enterprises in Switzerland with the very high figures for Belgium. It is interesting to note that the investments of Belgian Multinational Enterprises abroad are also of similar great importance.

[71] L'Express (Paris), 6 December 1980; Le Soir (Brussels), 4 December 1980.

[72] In Germany, there is even a gentleman's agreement among the banks, several business and industry organizations, and the federal government, which provides that no sale of the control of an enterprise will be made to foreigners without consultation.

[73] Barbara Emerson, Leopold II: The Kingdom and the Empire, chapter XXI (London, 1979).

[74] *See* Yellon and Welsh, *Counseling Foreign Banks on United States Bank Acquisitions: The Foreign Banker Meets His U.S. Lawyers*, 2 J. Comp. Corp. L. & Sec. Reg. 303-333 (1979).

[75] *See* section 2B(i) *supra* at 143.

[76] EEC Treaty, articles 59 to 66.

[77] *See* section 2B(ii) *supra* at 144.

[78] On these problems, *see* the very interesting paper presented by Mr. Troberg, *Freedom of Establishment, Freedom to Supply Services: The Field of Financial Institutions and Their Operation*, at the 1980 Brussels Seminar of the International Faculty for Corporate and Capital Markets Law [available from the editors of this journal]. *See also*, Judgment of 26 November 1975 (Coenen), [1975] ECR 1547 (as an exception to the general rule, a location and a permanent address may be required for services of a special nature that need supervision which can be effected only on the spot).

[79] *See, in general*, articles 100 and 101, and especially in reference to banks, articles 57, para. 2 and 61, para. 2; *see also* articles 54, para. 2 and para. 3, and 63, para. 2 and para. 3.

[80] The EEC directives or proposals or Codes of conduct in the area of securities markets and regulations will not be treated here, for they are more closely related to problems of foreign portfolio investment and foreign issues than to problems of foreign direct investment. The same is true for directives, and proposals for directives, in the corporate and accounting fields.

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

[81] OJEC, nr. L 194 of 16 July 1973. *See*, as regards freedom to provide banking services, the interesting Judgment of 24 October 1978 (Société Générale Alsacienne de Banque), [1978] ECR 1971.

[82] OJEC, nr. L 322 of 17 December 1977. An excellent and comprehensive comment on the directive of 1977 has been published by Le Brun, *Une première étape vers l'harmonisation européenne des réglementations bancaires,* 1979 Revue de la Banque (Brussels) 25-57. *See also* the paper presented by Mr. Clarotti, *The Harmonization of Legislation Relating to Credit Institutions,* at the 1980 Brussels Seminar of the International Faculty for Corporate and Capital Markets Law [available from the editors of this journal].

[83] The time limit for implementation of the 1977 directive was December 1979; but several Member States have not yet complied.

[84] For an interesting general view on the present situation, *see* IBRO, The Regulation of Banks in the Member States of the EEC (1978).

[85] *See* article 3 of the 1977 directive, and Le Brun, *supra* note 82, nr. 2.2.1.4.

[86] *See also* Le Brun, *supra* note 82, nr. 2.2.3, and, as regards branches of EEC credit institutions, nr. 2.2.2.2. With respect to the subsidiaries of non-EEC credit institutions, an issue not covered by article 9, *see* Le Brun, *L'harmonisation des législations bancaires et les autorités nationales de contrôle,* in The Development of Financial Institutions in Europe, 1956-1976, at 350 ff. (Sijthoff-Leiden, 1977).

[87] Banking Act 1979, chapter 37, HMSO 1979; *see also* Watson, *The U.K. Banking Act 1979*, 1980 DPCI 71-81; and Revell, *The Regulation on Banks and the New English Banking Law,* 1981 Revue de la Banque (Brussels) 5-28.

[88] And even competition among authorities. *See* Giddy and Allen, *International Competition in Bank Regulation,* 1979 Banca Nazionale des Lavoro Quarterly Review 311-326; *compare* Revell, *The Complementary Nature of Competition and Regulation in the Financial Sector,* 1980 Revue de la Banque (Brussels) 9-32.

[89] Federal Act on Banks and Savings Banks, 8 November 1934, revised on 11 March 1971. By an "urgent" vote, new rules on foreign banks were first introduced by a Federal Decree of 21 March 1969. A new revision of the Act is presently in preparation.

[90] As regards branches, *see* Decree of the Federal Banking Commission of 14 September 1973.

[91] This requirement can also be found in many other European countries, including EEC countries. For example, Italy demands reciprocity for non-EEC subsidiaries and The Netherlands, for non-EEC branches. *See* items 25 and 27 of the summary table that forms the annex to IBRO, *supra* note 84, and its corresponding chapters. Clearly, the content and the application of the requirement of reciprocity may be extremely different from one country to another. Such differences also result from the degree of independence of the authority in charge

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of granting licences; this may be an independent commission as in Switzerland or Belgium, the central bank, the Minister of Finance, or the government itself.

[92] Hirsch, *La surveillance des banques en Suisse,* in Festschrift für Johannes Bärmann at 467 (München, 1975):

> La raison sociale de ces banques ne doit pas permettre de penser qu'il s'agit de banques suisses. D'autre part, la banque "*en maine étrangères*" doit donner à la Banque Nationale l'assurance qu'elle adhèrera à la politique suisse en matière monétaire et dans le domaine du crédit; elle est tenue de donner certains renseignements à la Banque Nationale à cet effet. En outre, la majorité des membres de la direction doit être domiciliée en Suisse; ceux qui sont domiciliés à l'étranger ne peuvent pas signer individuellement ni collectivement entre eux. Toutes ces règles ne soulèvent pas de difficultés.

[93] *See* Hirsch, *supra* note 92, at 467-468; Hirsch, *La Commission fédérale des banques en 1974,* La société anonyme suisse, at 51-53; Chapuis, *Le statut des banques étrangères en Suisse,* 1976 DPCI 119-138; Müller, *La surveillance des banques en Suisse,* 1980 Revue de la Banque (Brussels) 61-76.

[94] Real Decreto nr. 1388/78 of June 1978 on foreign banks in Spain; *see* Fernandez Rozas, *La nouvelle réglementation de la banque étrangère en Espagne,* 1978 DPCI 363-381. The first draft of the decree was still significantly restrictive.

[95] *See* Engle, *International Investment,* 9 Harv. Int'l L.J. 305-317 (1968).

[96] Bank Act 1980, chapter 40; see Robinson, Hoffstein and Thompson, *Foreign Banks in Canada - The Door Opens,* 2 The International Contract 11-20 (1981).

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

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RESTRICTIONS ON FOREIGN INVESTMENT: DEVELOPMENTS IN JAPANESE LAW

Misao Tatsuta

MR. HAWES: Now, I would like to have Mr. Misao Tatsuta from Kyoto tell us about the Japanese situation.

MR. TATSUTA: Thank you, Doug. Since the age of the gods, Japan has repeatedly opened and closed its door. According to legend, sunshine returned to our ancestors when the Goddess of the Sun peeped through a crack by the rock door of a cave where she had locked herself. After three hundred years of isolation under the Shogun, Japan opened its door wide and achieved rapid modernization in the twentieth century--thanks to the advanced civilization and technologies of the Western countries.

Japanese entrepreneurs, however, found it difficult to launch their own ventures. When the time was ripe in terms of the national economy, they found that foreign capital and technology already controlled the main industries, and markets were hard to enter [1]. This pre-war experience prompted our country to maintain a restrictive policy toward foreign investment in post-war times, when our economy had to be rebuilt from almost nothing.

1. EXCLUSIONARY LAW AND ITS DEMISE

The Foreign Investment Law of 1950 [2] prohibited the inflow of foreign capital but made exceptions for selected desirable investments [3]. Gradually the exceptions were broadened, especially after 1964 when Japan joined the OECD [4]. In May 1973, the government replaced the previous fifty-fifty principle for foreign capital investment with a one hundred percent liberalization [5], in accordance with the OECD Code. The original statutory structure, however, remained unchanged; and the very existence of this prohibitive statute, combined with its procedural complexity, gave the impression that Japan still maintained a closed-door policy. Criticism from abroad grew louder as overseas activities by Japanese enterprises attracted more attention.

The Foreign Investment Law was finally abolished and replaced by the Foreign Exchange and Foreign Trade Control Law of 1979 [6], which took effect December 1, 1980. This new statute reversed the former exception-to-the-rule emphasis and imposed restrictions only in exceptional cases. Rules and regulations under the statute provided for streamlined procedures [7]. For example, a written contract and its time-consuming translation are no longer required with an application for validation. Furthermore, notification procedures are now free from conditions or terms formerly imposed through the exercise of administrative guidance.

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2. ACQUISITION OF SHARES BY ALIENS

Under the new regime acquisitions of corporate shares by foreigners are classified according to three categories: (1) portfolio investment, (2) direct domestic investment, and (3) acquisition of controlling ownership.

A. Portfolio Investment

When a non-resident's holding, after purchase, is less than ten percent of the aggregate outstanding shares in a listed corporation, such purchase is denominated portfolio investment [8]. This type of transaction is subject to a notice requirement and a twenty day waiting period [9]. Practically speaking, however, these requirements can be disregarded since insofar as the purchase is made through a designated securities company there is no need to notify the Finance Minister of the transaction [10]. There are twenty-six designated securities companies, including four foreign brokers [11].

It is true that in emergency cases (such as those specified in article 7 of the OECD Code) the Finance Minister may impose special regulations [12]. However, in its policy announcement of December 16, 1980 [13], the Foreign Exchange Council emphasized that resort to such emergency regulations should be confined to a necessary minimum, and that international harmony should always be borne in mind.

B. Direct Domestic Investment

Direct domestic investment occurs when a foreign investor's holding after purchase will be ten percent or more of the aggregate outstanding shares in a listed corporation, or when a foreign investor plans to acquire any number of shares in an unlisted corporation [14]. Prior to this type of transaction, the buyer must file a notification statement with the Minister in charge of the industry involved. A statutory waiting period of thirty days follows, but it may be accelerated in normal circumstances to about fifteen days [15]. The same requirements apply if a foreign company wishes to establish a branch or make a substantial change in its business [16]. If the government finds it necessary to determine whether the transaction might imperil the national security or cause substantial adverse effects in related Japanese industries, the waiting period may be extended to five months. And if the government decides that it is probable that these adverse consequences will take place, it may order the transaction altered or suspended [17].

The Cabinet Decision of December 26, 1980 states that with regard to direct domestic investments the government shall administer the Foreign Exchange and Foreign Trade Control Law in accordance with the OECD Code [18]. It directs, furthermore, that for the moment the government shall continue to deal cautiously with direct domestic investments in primary industries (*i.e.*, agriculture, forestry and fisheries, mining, oil, leather, and leather products manufacturing) while it maintains efforts to loosen restrictions on investments in these industries in response to future variations in the social and economic circumstances of the country [19].

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

C. Acquisition of Controlling Ownership

With respect to acquisition of controlling ownership, the government retains the power to screen acquisition of corporate shares by foreigners through the selection of certain issuers for special treatment. The government may designate issuers for this special screening process if it seems necessary to determine whether share holdings of twenty-five percent or more by foreigners might imperil the national security, disturb the maintenance of public order, hamper the protection of public safety, or cause substantial adverse effects in the national economy [20].

There were hot debates on whether this sort of regulation should be retained. The argument that prevailed was as follows: those who have been accustomed to the previous regime still need time to prepare themselves for its complete dismantlement [21]. Since this rationale seems to be less than indisputable, the special control continues "for the time being" only and is specified not in the body of the law, but in supplementary provisions [22]. It would be fair to say that the Cabinet Decision of December 26, 1980 [23] (which I have mentioned in connection with direct domestic investment) applies to this restriction--that is, the government must make efforts to liberalize acquisition of controlling ownership, as well as lesser purchases, in the primary industries. Under the old regime, one of the tests for a case-by-case scrutiny was whether the incumbent management consented to the foreigner's acquisition. Under the present statute, however, designation may be made irrespective of management approval.

In an announcement on November 28, 1980 [24], the government designated eleven corporations [25] for this special screening process. It is reported that a Hong Kong investor who has a substantial holding in one of these corporations, Katakura Industries Co., brought a suit against the Japanese government alleging that the selection of that company was unwarranted and therefore unlawful [26]. We are much concerned about the outcome of this suit.

A foreigner who plans to acquire shares in a designated corporation must first use a resident agent to file a confirmation request with the Minister of Finance, via the Bank of Japan. Within forty days prior to the planned transaction, the foreigner must obtain a confirmation declaring whether or not the planned acquisition falls within the shareholding limit [27]. In addition to the confirmation request, the foreigner must file a notification statement in the same manner [28]. If the Minister finds it necessary to determine if the acquisition might cause one of the adverse effects that I mentioned earlier, the planned transaction is subject to the same process of review that is used with a direct domestic investment [29].

3. OBSTACLES TO A TAKEOVER

Once a foreigner has cleared the hurdle of foreign investment restrictions, he or she toes the line along with domestic investors. Issuers may not restrict the transfer of listed shares due to self-regulation by stock exchanges [30]. There are, however, several obstacles for an investor, domestic or foreign, to overcome before gaining control of a target company.

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A. Tender Offer Legislation

The tender offer provisions in the Securities and Exchange Law tend to support incumbent management. A buyer must file a tender offer statement with the Finance Minister and then observe a ten-day waiting period. During this time, a copy of the statement is sent to the target company [31]. These rules resemble some state tender offer statutes in the U.S. [32].

B. Stock Exchange Reporting Requirements

If the stock exchange suspects that a buyer is secretly purchasing a substantial number of shares, which might cause extraordinary price movement in a particular stock, the exchange may require special reporting of such stock. Member firms are then obliged to report the details of transactions in that stock. When the exchange deems it necessary, it gives member firms relevant information about the stock [33]. Thus, it becomes difficult to buy the stock anonymously.

This rule originated to cope with a maneuver in which a purchaser would acquire a large holding--thereby driving up the price--and would then try to sell the shares to management at the heightened price. The buyer's intention to sell rather than to acquire is, however, hard to prove. Therefore, the rule may be applied in various situations; and it may often have the effect, perhaps contrary to the stock exchange's intent, of tipping the scales in favor of the incumbent management.

C. Cumulative Voting

Under the Commercial Code, as amended in 1974, cumulative voting is not mandatory [34], and virtually all corporations have adopted charter provisions that dispense with it. Thus, it is almost impossible for minority shareholders to have representatives on the board of directors.

D. Qualification of Directors

The former attitude of Japanese management toward foreign participation is exemplified by the following case. In 1968, Toyota Motor Co., Ltd. added a new provision to its charter requiring that directors and supervisors be of Japanese nationality. A Japanese shareholder brought an action alleging that the charter amendment was void, but the district court held that a nationality requirement was not unreasonable discrimination in contravention of the equal protection clause of the constitution. Furthermore, it was held that such matters should be left to corporate autonomy [35]. The plaintiff did not appeal, and contemporary commentators supported the court's decision. Such discrimination is, however, obviously inconsistent with the national policy of liberalizing capital movements; and it is doubtful that a court would render the same opinion today. At any rate, Toyota subsequently deleted the charter provision in question, and I do not know of any corporation that currently has such a provision.

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4. ADMINISTRATIVE GUIDANCE

The Japanese government is widely known--or notorious--for its extensive use of so-called "administrative guidance". By means of this technique the government can attain its policy goals without explicit statutory authority [36]. This has both advantages and disadvantages. It insures the governmental flexibility that is needed for quick response to changing circumstances; and it can reinforce self-regulation by encouraging each industry to attain moral standards higher than the statutory minimum. Sometimes the government avoids coercive measures by issuing warnings or recommendations first, so that an innocent violator may comply without losing face. By and large, government officials are capable, industrious, and honest. In most cases they can be relied upon to select appropriate administrative techniques.

On the other hand, administrative, or non-statutory, guidance obscures the border between what can be done and what cannot be done. This results in a low measure of clarity and predictability. It may happen that the officials in charge are so concerned with their own regulatory business that they lose a broader perspective. For example, MITI's [37] administrative guidance could possibly conflict with the FTC's [38] competition policy [39].

Several years ago, the Hong Kong investor whom I mentioned earlier tried to purchase a block of shares in a leading paper manufacturing company. It was reported that the Securities Bureau of the Ministry of Finance advised brokers not to accept buy orders from him [40]. This is one of the shameful examples of administrative guidance. When this investor purchased Katakura shares, however, the Securities Bureau did not repeat its folly, and I believe such mistakes will be avoided in the future.

Even with respect to domestic matters, criticism has been increasing against the official habit of resorting to administrative guidance [41]. In the context of international business--where foreigners are not familiar with this Japanese technique--our government should refrain from using administrative guidance. Even the wise exercise of non-statutory guidance has the potential to evoke misunderstanding and mistrust.

5. FUTURE POTENTIAL

The new regime that was launched last December attains, both in form and in substance, a level of liberalization that is consistent with the OECD Code of Liberalization of Capital Movements [42]. The only area open to question is our transitional restriction on acquisition of controlling ownership. We have to guard against any unwarranted designation of issuers [43], and we must seek to have this special restriction discarded as soon as possible.

At the same time, I hope that foreign investors will conduct adequate investigations before entering the Japanese market. It is unfortunate and unfair if they regard some of our business practices as discriminatory just because they are unfamiliar with them. For instance, the obstacles to a takeover that I have mentioned are not limited to foreign investors; domestic investors as well find it difficult to take over an existing enterprise. They face resistance not only from management, but also from the employees at large.

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Employees regard their jobs as life-long positions and feel as though they belong to a family. They are likely to be resentful of an invasion from outside the company; and customers and suppliers have similar feelings. These facts cannot be altered by legislation or government policy.

Without a willingness to be integrated into this type of environment--which takes considerable time--emissaries from abroad, even with a deep pocket, are not likely to be successful in conducting continuous business in Japan [44]. I hope that the door will always remain open; so that together, hand in hand in our islands, we may enjoy the sunshine given by the Goddess of the Sun.

NOTES

[1] For example, the market for soda and other chemical products was dominated by English and German products until World War I. Toyo Keizai Shinposha (ed.), Nippon No Kaisha Hyakunenshi (Hundred Years of Japanese companies 196 (1975). Also, when the predecessor of Toshiba Electric Co. entered the electric bulb market at the beginning of this century, it could not compete with foreign products and could not refrain from forming a joint venture with General Electric Co. Seki (ed.), Toshiba Hyakunenshi (Hundred years of Toshiba Electric Co.) 24-25 (1977). One of the reasons why foreign products dominated Japanese markets was, in addition to the fact that domestic technologies were underdeveloped, that Japan did not have the power to fix tariffs on its own initiative until 1911. 1. Takahashi, Nippon Kindai Keizai Hattatsushi (Development of Japanese modern economy) 204-218 (1973).

[2] *Gaishi ni kansuru Hōritsu,* Law No. 163, 1950.

[3] Every foreign investment was dependent upon the validation which was granted through case-by-case scrutiny by the government. Foreign Investment Law art. 8 and art. 11.

[4] Organization for Economic Cooperation and Development, Code of Liberalization of Capital Movements (original 1961). Japan joined it with several reservations in 1964. See Annex B to the Code.

[5] The Cabinet Decision of June 6, 1967 declared that in certain categories of industry the competent minister would automatically approve an application for direct investment in the form of company formation, if the aggregate foreign holdings did not exceed fifty percent and certain other requirements were met. The Cabinet Decision of April 27, 1973 (Liberalization of Inward Investment) superseded the earlier decision and declared that approval of share acquisitions by foreign investors pursuant to article 11 of the Foreign Investment Law would be given automatically by the competent minister in accordance with the OECD Code, except in case of certain categories of industry.

[6] *Gaikokukawase oyobi Gaikokubōeki Kanrihō*, originally Law No. 228, 1949, as amended by Law No. 65, 1979. This amended law [hereinafter referred to as FECL (Foreign Exchange Control Law)] is appended to this chapter *infra* at 169.

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

[7] Foreign Exchange Control Order (*Gaikokukawase Kanrirei*), Cabinet Order No. 260, 1980 [hereinafter referred to as FEC Order]; Direct Domestic Investment Order (*Tainai Chokusetsutōshi tō ni kansuru Seirei*), Cabinet Order No. 261, 1980 [hereinafter referred to as DDI Order]; Direct Domestic Investment Rule (*Tainai Chokusetsutōshi tō ni kansuru Meirei*), Prime Minister's Office and other Ministries Rule No. 1, 1980 [hereinafter referred to as DDI Rule].

[8] FECL art. 20 item 5, art. 26 para. 2 items 1 and 3: DDI Order art. 2 para. 5.

[9] FECL art. 22 para. 1 item 3, art. 23 para. 1.

[10] FECL art. 22 para. 1 proviso.

[11] The Finance Minister has designated the following firms upon their application pursuant to FEC Order art. 12 para. 7; Foreign Exchange Control Rule (*Gaikokukawase no kanri ni kansuru Shōrei*), Ministry of Finance Rule No. 44, 1980 art. 12.

Nomura Securities Co.
Nikko Securities Co.
Daiwa Securities Co.
Shin-Nippon Securities Co.
Nippon Kangyo Kakumaru Securities Co.
San-yo Securities Co.
Wako Securities Co.
Okasan Securities Co.
Yamatane Securities Co.
Osakaya Securities Co.
Daiichi Securities Co.
Yachiyo Securities Co.
Toyo Securities Co.
Marusan Securities Co.
Koa Securities Co.
Nashonaru Securities Co.
Koyanagi Securities Co.
Toko Securities Co.
Meiko Securities Co.
Tachibana Securities Co.
Nichiei Securities Co.
Merrill Lynch International Bank, Inc., Tokyo and Osaka Branches
Vickers, da Costa & Co., Tokyo Branch
Bache, Halsey, Stuart, Shields, Japan, Ltd., Tokyo Branch
Smith, Barney, Harris, Upham International, Inc., Tokyo Branch

Kei, *Kaisei Gaikokukawase oyobu Gaikokubōeki Kanrihō no Shikō ni tsuite: Shōken kankei o Chūshin to shite* (On enforcement of Amended Foreign Exchange and Foreign Trade Control Law: focusing upon securities), 33 Kigyō kaikei (Accounting) 285 (1981).

[12] FECL art. 23 para. 2 through 8; FEC Rule art. 13.

[13] *Gaikokukawase tō shingikai* (Foreign Exchange Council), *Yūjikisei ni kansuru kihontekina Kangaekata* (Basic policy concerning emergency control), Dec. 16, 1980.

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[14] FECL art. 26 para. 2 items 1 and 3; DDI Order art. 2 para 5. "Foreign investor" is defined by FECL art. 26 para. 1 and DDI Order art. 2 paras. 1 and 2.

[15] FECL art. 26 paras. 3 and 4; DDI Order art. 2 paras. 10 through 13; DDI Rule art. 2 paras. 3 and 4. Fukui (ed.), Atarashii gaikokukawase kanrihō no kaisetsu (Explanation of the new Foreign Exchange Control Law) 53 (1980).

[16] FECL art. 26 para. 2 items 4 through 7; DDI Order art. 2 paras. 6 through 9.

[17] FECL art. 27 paras. 1 through 4 and 7; DDI Order art. 3.

[18] *Tainai Chokusetsutōshi tō no Un'yōhōshin ni tsuite* (On the policy of administering direct domestic investments), Cabinet Decision, Dec. 26, 1980.

[19] These industries (as well as retail trade operations) were listed in Annex 1 to the Cabinet Decision of April 27, 1973, *supra* note 5, in order to indicate that the acquisition of shares of an enterprise, either newly established or existing, which belongs to any of these industries would continue to be treated as before, *i.e.*, to be screened on a case-by-case basis.

[20] FECL Supplementary Provisions art. 2; DDI Order art. 7 paras. 4 and 5. This restriction applies to acquisition of shares by individual non-residents, corporations, and other organizations established pursuant to foreign law or headquartered abroad.

[21] Seki, *Foreign Exchange Law; Major Points in the Revision of the Foreign Exchange and Foreign Trade Control Law,* 1 Japan Business Law Journal 18 (1980); Fukui, *supra* note 15, art. 57-58.

[22] *See supra* note 20.

[23] *See supra* note 18.

[24] *Gaikokukawase oyobi Gaikokubōeki Kanrihō narabini Tainai Chokuseutstōshi tō ni kansuru Seirei no Kitei ni motozuki Shinsa no Taishō to subeki Kaisha oyobi Tokutei no Kaisha ni tsuite tokuni Hitsuyō ga aru to mitomete sadameru Ritsu o sadameru Ken* (Re-designation of corporations subject to the screening process and designation of ceilings for foreigners' holdings of shares in certain corporations pursuant to the Foreign Exchange and Foreign Trade Control Law and the Direct Domestic Investment Order), Announcement No. 1, 1980, Ministry of Finance; Ministry of Public Welfare; Ministry of Agriculture, Forestry and Fishery; and Ministry of International Trade and Industry.

[25] The designees and respective ceilings are as follows (blanks show that the ceiling is 25 percent):

Designated Issuer	Ceiling in Percentage
Sankyo Co.	-
Katakura Industries Co.	-
Arabian Oil Co.	-
Fuji Electric Co.	26
Hitachi Ltd.	30
Tokyo Keiki Co.	32
General Sekiyu K.K.	49
Showa Oil Co.	50

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

Designated Issuer	Ceiling in Percentage
Mitsubishi Oil Co.	50
Toa Nenryo Kogyo K.K.	50
Koa Oil Co.	50

[26] *Nippon Keizai Shimbun* (Japan Economic Journal), Feb. 24, 1981, at 15; *id.*, Mar. 3, 1981, at 2; *id.*, July 3, 1981, at 13; Shōjihōmu (Commercial Law Review) No. 899 at 30 (1981).

[27] FECL Supplementary Provisions art. 2 para. 3; DDI Order art. 8 paras. 5 and 6; Ministerial Rule Concerning Confirmation of Stock Acquisitions by Individual Non-residents and the like *(Hikyojūsha dearu Kojin tō ni yoru Kabushiki tō no Shutoku no Kakunin tō ni Kansuru Shōrei)*, Ministry of Finance Rule No. 46, 1980.

[28] FECL Supplementary Provisions art. 3 para. 1; DDI Order art. 8 paras 1 through 4; DDI Rule art. 4.

[29] FECL Supplementary Provisions art. 4 paras. 5 and 6; DDI Order art. 9.

[30] *E.g.*, Tokyo Stock Exchange, Criteria for Stock Listing *(Kabuken jōjō shinsa kijun)* art. 2 para. 1 item 10; *id.*, Criteria for Delisting of Listed Stock *(Kabuken jōjō haishi kijun)* art. 2 para. 1 item 11.

[31] Securities and Exchange Law *(Shōkentorihikihō)*, Law No. 25, 1948, as amended by Law No. 46, 1971, arts. 27-2 and 27-3.

[32] Wilner and Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality,* 45 Fordham L. Rev. 1, 8 notes 37 & 38 (1976).

[33] *E.g.,* Tokyo Stock Exchange, Rule Concerning Stock to be Reported with Special Requirements *(Tokubetsu hōkoku meigara ni kansuru Kisoku)*, Oct. 11, 1978.

[34] Commercial Code *(Shōhō)* Law No. 48, 1899, art. 256-3 para. 1. Prior to the 1974 amendment, cumulative voting was mandatory if holders of one-quarter of the aggregate outstanding shares requested it.

[35] Ohba v. Toyota Motor Co., Ltd., 22 Kakyū minshū 549 (Nagoya Dist. Ct., Apr. 30, 1971).

[36] The government argues that it has statutory authority in the law stipulating the organization of respective ministries. Reply to the Director, Legal Bureau of the Cabinet, before the Budget Committee, House of Representatives, Mar. 12, 1974, Kōsei torihiki, No. 366 at 20 (1981).

[37] Ministry of International Trade and Industry *(Tsūshōsangyoshō)*.

[38] Fair Trade Commission *(Kōseitorihiki iinkai)* in charge of administering the Law Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade *(Shiteki dokusen no kinshi oyobi kōsei torihiki no kakuho ni kansuru Hōritsu)*, Law No. 54, 1947.

[39] Japan v. Sekiyu Renmei (Ass'n of Oil Refineries) et al., Hanrei jihō No. 983 at 26 (Tokyo High Ct., Sept. 26, 1980); Japan v. Idemitsu Kōsan K.K. et al., Hanrei jihō No. 985 at 6 (Tokyo High Ct., Sept. 26, 1980).

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[40] Kyū, *Honkon no Chōsen* (Challenge from Hong Kong), Chūō kōron, Nov., 1980, at 266-267.

[41] Yamauchi, *Gyōseishidō* (administrative guidance) 186-196 (1977).

[42] OECD, Code of Liberalization of Capital Movements, Arts. 1, 2, 3, 5, and 7.

[43] Daiwa Un'yu K.K., a trucking firm, failed to be designated as the twelfth corporation (*supra* note 25), due to reluctance on the part of the Finance Ministry, though the Transportation Ministry supported the company's position. The Katakura litigation (*supra* note 26) may have some effects on the government policy. *Nippon Keizai Shimbun* (Japan Economic Journal), June 3, 1981, at 1.

[44] Subcommittee on Trade of the Committee on Ways and Means, U.S. House of Representatives, United States-Japan Trade Report, at 16 (Sept. 1980).

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

APPENDIX XII

FOREIGN EXCHANGE AND FOREIGN TRADE
CONTROL LAW (FECL)

CHAPTER V DIRECT DOMESTIC INVESTMENTS, ETC.

(Notice, etc., of direct domestic investments, etc.)

Article 26. A "foreign investor" shall mean any one of those mentioned below, which performs any one of the direct domestic investments, etc., mentioned in each Item of the next Paragraph:

(1) A natural person who is a non-resident;
(2) A juridical person or other organization established under foreign legislation, or a juridical person or other organization having its main office in a foreign country;
(3) A company of which the number of stock or the amount of capital subscription directly owned by one or more of those mentioned in Item (1) and/or the preceding Item, and/or the number of stock or the amount of capital subscription designated by a Cabinet Order as being indirectly owned by the above-mentioned through another company or other companies, equal(s) or exceed(s) in the aggregate one-half (1/2) of that company's total stock issue or total subscribed capital; or
(4) Other than those mentioned in the preceding two Items, a juridical person or other organization of which a majority number of board members (which mean directors and other similar posts, which shall apply in this Item) or board members having representing power is occupied by persons mentioned in Item (1).

2. A "direct domestic investment, etc." shall mean an act which falls under any Item below:
(1) Acquisition of any company's stock or share (except for the acquisition by transfer from any one mentioned in each Item of the preceding Paragraph, and the acquisition of the stock of companies which is listed on the stock exchange defined by Article 2, Paragraph 11 of the Securities and Exchange Law, or the stock of companies which is designated by a Cabinet Order as being similar to the aforementioned listed one--collectively referred to as "listed companies, etc." in the next Item and Item (3)--);
(2) Transfer of stock or share(s) of any company other than the listed companies, etc., which was/were acquired by the transferer prior to his acquisition of non-resident status and has/have been continuously held by him up till the time of the transfer (limited to only such transfer as made by a non-resident natural person to any one mentioned in each Item of the preceding Paragraph);
(3) Acquisition of stock of any one of the listed companies, etc. (limited to only such instances whereunder either the ratio of the number of stock of a given company acquired by a given transaction against that company's total stock issue, or the aggregate ratio of the total number of stock of a given company which becomes to be possessed by an acquirer after a given act of acquisition plus the number of stock of the same company possessed by the juridical person or other organization designated by a Cabinet Order as having a special relationship with the acquirer through stock or share holding or other similar ways against that company's total stock issue equals or exceeds a ratio determined by a Cabinet Order which shall be not less than ten-hundredth (10/100));

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(4) Consent given to a substantial alteration of the objective of a company's business (limited to only such consent as given by one or more stockholder(s) or shareholder(s) who own(s) in total one-third (1/3) or more of that company's total stock issue or total subscribed capital);
(5) Establishment of a branch, etc., in Japan, or substantial alteration of the type or the business objective of a branch, etc., existing in Japan (limited to only such establishment and alteration as designated by a Cabinet Order, which is to be made by any one of those mentioned in Item (1) or (2) of the preceding Paragraph);
(6) Money lending to a juridical person having its main office in Japan in excess of an amount determined by a Cabinet Order (except for those lendings made as a business by a bank or other financial institution designated by a Cabinet Order, and lendings in our currency made by any one of those mentioned in Item (3) or (4) of the preceding Paragraph), of which the term exceeds one year; or
(7) Any other act designated by a Cabinet Order as being similar to any one of those mentioned in each of the preceding Items.

3. Any foreign investor who wants to make a direct domestic investment, etc., mentioned in any Item of the preceding Paragraph (except for those cases determined by a Cabinet Order, in consideration of such instances as inheritance, legacy, amalgamation of juridical persons, etc.) shall give a prior notice, as a Cabinet Order provides for, to the Minister of Finance and the Minister(s) in charge of the industry involved of those matters designated by the Cabinet Order such as the objective of the business, amount, time of execution, and others concerning that direct domestic investment, etc.

4. Any foreign investor who has given a notice under the provisions of the preceding Paragraph concerning the direct domestic investment, etc., mentioned in Paragraph 2 (hereinafter referred to as "direct domestic investment, etc.,") shall not execute that direct domestic investment, etc., until a period of thirty (30) days has elapsed, counting from the day of receipt of the notice by the Minister of Finance and the Minister(s) in charge of the industry involved. However, the Ministers may shorten this period when they deem it not specifically harmful, judging from the objective of the business, etc., of the direct domestic investment, etc., under notice.

5. Any person other than a foreign investor (including a juridical person or other organization, which shall also apply to Paragraph 1 of the next Article) who performs any transaction or act tantamount to a direct domestic investment, etc., on behalf of a foreign investor but not in the latter's name shall be deemed as a foreign investor, and the provisions of the preceding two Paragraphs shall apply to such a person.

(Screening of the conditions of direct domestic investments, etc., and recommendation of alteration thereof, etc.)

Article 27. When a notice is given to the Minister of Finance and the Minister(s) in charge of the industry involved under the provisions of Paragraph 3 of the preceding Article (including a notice given by a person other than a foreign investor who is deemed as a foreign investor under the provisions of Paragraph 5 of the same Article, which shall also apply to the next paragraph and Paragraph 8), and the Ministers deem it necessary to make an inquiry in order to determine whether the direct domestic investment, etc., under notice, if executed, would cause apprehensions as to the occurrence of any of the consequences mentioned in Item (1) or (2), or whether the direct domestic investment, etc., under notice falls under Item (3) or (4), the Ministers may extend the period during which the execution of that direct domestic investment, etc., is prohibited up to four (4) months, counting from the day of their receipt of the notice:

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

(1) It might imperil the national security, disturb the maintenance of public order, or hamper the protection of the safety of the general public;
(2) It might adversely and seriously affect activities of our business enterprises engaging in a line of business similar or related to the one to which the direct domestic investment, etc., is to be made, or the smooth performance of our national economy;
(3) Because it is made by a foreign investor with whose country no treaties or other international agreements are concluded by our country in regard to the direct domestic investments, etc., its particulars are required to be altered, or its execution is required to be suspended, so as to make conditions substantially equal to those allowed to our national's direct investment activities (which mean those tantamount to direct domestic investment, etc., mentioned in each Item of Paragraph 2 of the preceding Article) in that country; or
(4) When seen from its purpose of the use of funds and others, it falls under, in whole or in part, the capital transactions upon which an obligation to obtain a license is imposed under the provisions of Article 21, Paragraph 2, and therefore its particulars are required to be altered, or its execution is required to be suspended.

2. When a notice is given to the Minister of Finance and the Minister(s) in charge of the industry involved under the provisions of Paragraph 3 of the preceding Article, the Ministers deem that, if the direct domestic investment, etc., under notice were executed, it would cause apprehensions as to the occurrence of any one of the consequences mentioned in Item (1) or (2) of the preceding Paragraph, or that the direct domestic investment, etc., under notice falls under Item (3) or (4) of the same Paragraph, they may, upon hearing the opinion of the Committee on Foreign Exchange and Other Transactions mentioned in Article 55-2, recommend the party which gave that notice, as a Cabinet Order provides for, either to alter the particulars of that direct domestic investment, etc., or to suspend the execution thereof, provided that such a recommendation is given within the period mentioned in the same Paragraph, or within the extended period provided in the next Paragraph, counting from the day of their receipt of the notice.

3. When the Committee on Foreign Exchange and Other Transactions mentioned in Article 55-2 is asked for its opinion for the inquiry provided in Paragraph 1, and tenders its intimation that to form its opinion within the period of four (4) months as provided in the same Paragraph is difficult due to the nature of the subject matter, the period provided in the same Paragraph during which the execution of the direct domestic investment, etc., is prohibited shall become five (5) months, irrespective of the provisions of the same Paragraph.

4. The party who is given recommendation under the provisions of Paragraph 2 shall inform the Minister of Finance and the Minister(s) in charge of the industry involved whether it accedes to the recommendation or not within a period of ten (10) days, counting from the day of its receipt of the recommendation.

5. The party which has informed its accession to the recommendation under the provisions of the preceding Paragraph shall execute the direct domestic investment, etc., concerning the recommendation in accordance therewith.

6. The party which has informed its accession to the recommendation under the provisions of Paragraph 4 may execute the direct domestic investment, etc., concerning the recommendation, before a period of four (4) months (or five (5) months when the period is extended under the provisions of Paragraph 3) has elapsed, counting from the day when he gave the notice thereof, irrespective of the provisions of Paragraph 1 or Paragraph 3.

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7. When the party which has been given recommendation under the provisions of Paragraph 2 either fails to inform or informs its non-accession thereto under the provisions of Paragraph 4, the Minister of Finance and the Minister(s) in charge of the industry involved may direct it to alter the particulars of the relevant direct domestic investment, etc., or to suspend the execution thereof, provided that such a directive is served within the period provided in Paragraph 1 or the extended period provided in Paragraph 3, counting from the day of their receipt of the notice thereof.

8. When the Minister of Finance and the Minister(s) in charge of the industry involved deem that, due to the change of economic situations or any other reason, apprehensions as to the occurrence of the consequences mentioned in Item (1) or (2) of Paragraph 1 cease to exist even if the direct domestic investment, etc., notifed under the provisions of Paragraph 3 of the preceding Article were executed, or that the direct domestic investment, etc., under notice ceases to be considered as falling under Item (3) or (4) of the same Paragraph, they may withdraw, in whole or in part, their recommendation to alter the particulars of the said direct domestic investment, etc., given to the party who has informed its accession thereto under the provisions of Paragraph 4, or their directive to alter such particulars served under the provisions of the preceding Paragraph.

9. In addition to those provided in each of the preceding Paragraphs, a Cabinet Order shall provide for the procedures of the recommendation to alter the particulars of the direct domestic investment, etc., or to suspend the execution thereof, and other necessary matters concerning the recommendation.

Supplementary Provisions

(Date of coming into force)

Article 1. The date of the coming into force of this Law shall be determined article by article by Cabinet Orders, which shall be not later than June 30, 1950.

(Special rules regarding acquisition of stock by non-resident natural persons, etc.)

Article 2. For the time being, when the Minister of Finance and the Minister(s) in charge of the industry involved deem it necessary to make an inquiry in order to determine whether apprehensions as to the occurrence of any of the below-mentioned consequences might ensure from the possession of certain company's stock, etc., in excess of a certain quantity (which mean the stock of the listed companies, etc., mentioned in Article 26, Paragrph 2, Item (1), and other securities designated by a Cabinet Order, which shall apply hereinafter) by any non-resident natural person, and/or juridical person or other organization established under foreign legislation, and/or juridical person or other organization having its main office in a foreign country (hereinafter collectively referred to as "non-resident natural persons, etc."), the Ministers may designate, as a Cabinet Order provides for, certain companies which issue such stock, etc., as those subject to such an inquiry:
(1) It might imperil the national security, disturb the maintenance of public order, or hamper the protection of the safety of the general public; or
(2) It might adversely and seriously affect the smooth performance of our national economy.

2. "The Minister(s) in charge of the industry involved" given in the preceding Paragraph shall be the one determined by a Cabinet Order as being in charge of the business being carried out by a company, of which stock, etc., is to be acquired as mentioned in the same Paragraph.

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3. "Stock, etc., in excess of a certain quantity" given in Paragraph 1 shall mean stock, etc., of a certain company of which the number (in the case of stock, the number thereof, and in the case of other securities, the number thereof translated into a stock equivalent in accordance with a formula provided by a Cabinet Order, which shall apply in this Paragraph) already possessed by non-resident natural person(s), etc. (including those possessed by any person--including a juridical person or other organization, which shall apply hereinafter--other than non-resident natural persons, etc., on behalf of the latter but not in the latter's name, and excluding those having been acquired by any non-resident natural person, etc., prior to his acquisition of non-resident status and continuously possessed thereafter), plus the number of stock, etc., of the same company to be newly acquired by any non-resident natural person, etc. (including those to be acquired by a person other than a non-resident natural person, etc., on behalf of the latter but not in the latter's name) equals or exceeds a ratio determined by a Cabinet Order which shall be not less than twentyfive-hundredth (25/100) of that company's total stock issue.

Article 3. When the designation of companies has been made under the provisions of Paragraph 1 of the preceding Article, and any non-resident natural person, etc., is to acquire thereafter stock, etc., in excess of the certain quantity of any one of such designated companies (except for the acquisition of stock of the listed companies, etc., mentioned in Article 26, Paragraph 2, Item (3)), he shall, unless a Cabinet Order otherwise provides for, give a prior notice, as a Cabinet Order provides for, to the Minister of Finance and the Minister(s) in charge of the industry involved of those matters as designated by the Cabinet Order such as the quantity of stock, etc., to be acquired and others, and for such acquisition the provisions of Article 22, Paragraph 1 shall not apply.

2. Any non-resident natural person, etc., who is to acquire stock, etc., of any company designated under the provisions of Paragraph 1 of the preceding Article shall request the Minister of Finance, as a Cabinet Order provides for, to confirm whether or not the intended acquisition falls under the stock, etc., in excess of certain quantity as mentioned in the same Paragraph.

3. Any non-resident natural person, etc., who has given a notice under the provisions of Paragraph 1 concerning his acquisition of stock, etc., in excess of the certain quantity as mentioned in Paragraph 3 of the preceding Article, shall not acquire the stock, etc., in excess of the certain quantity, under notice, until a period of thirty (30) days has elapsed, counting from the day of receipt of the notice by the Minister of Finance and the Minister(s) in charge of the Industry involved. However, the Ministers may shorten this period when they deem it not specifically harmful, judging from the quantity of the stock, etc., to be acquired in excess of the certain quantity and other matters mentioned in the notice.

4. When any person other than a non-resident natural person, etc., is to acquire stock, etc., in excess of the certain quantity on behalf of the latter but not in the latter's name, the former person shall be deemed as a non-resident natural person, etc., and the provisions of the preceding three Paragraphs shall apply to such a person.

5. When a notice is given to the Minister of Finance and the Minister(s) in charge of the industry involved under the provisions of Paragraph 1 (including a notice given by a person other than a non-resident natural person, etc., who is deemed as a non-resident natural person, etc., under the provisions of the preceding Paragraph, which shall apply also to the next Paragraph), and the Ministers deem it necessary to make an inquiry in order to determine

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whether the acquisition of stock, etc., in excess of the certain quantity, if made, would cause apprehensions as to the occurrence of any consequences mentioned in either Item of Paragraph 1 of the preceding Article, they may extend the period during which the acquisition thereof is prohibited up to four (4) months, counting from the day of their receipt of the notice.

6. The provisions of Article 27, Paragraph 2 through Paragraph 7, and Paragraph 9 shall be applicable mutatis mutandis to the notice given under the provisions of Paragraph 1, and a Cabinet Order shall provide for the technicalities of such mutatis mutandis application.

Article 4. When any person other than a non-resident natural person, etc., is to acquire any stock, etc., on behalf of the latter but not in the latter's name (except for the acquisition of the stock, etc., falling under the provisions of Paragraph 4 of the preceding Article), the former person shall, unless a Cabinet Order otherwise provides for, give a prior notice to the Minister of Finance, as a Cabinet Order provides for, of those matters as designated by the Cabinet Order such as the quantity of the stock, etc., to be acquired and others.

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DEVELOPMENTS IN HARMONIZATION OF ACCOUNTING STANDARDS

LeRoy J. Herbert

MR. HAWES: We are now going to shift gears a bit and talk about special legal and accounting problems in multinational activity. The first talk in that field will be on the harmonization of accounting standards, and the second will be about comparative disclosure and possibilities of harmonization in that area. We should listen to Roy Herbert's discussion of accounting harmonization in order to see what it portends for other kinds of harmonization, because certainly the accountants have been at harmonization efforts as long as anyone.

1. HARMONIZATION

MR. HERBERT: The issue of harmonization of accounting standards has received growing attention over the last decade. The process has been speeded up by a variety of interest groups, including
(1) The users of financial statements. The impact of many companies on capital markets, commodity markets, on labor, etc., goes beyond national borders. Information included in the financial statements of these companies is, however, of only limited value to users in other countries if they are not familiar with the accounting standards underlying these statements.
(2) International and multinational companies operating in several countries and having their shares quoted on several stock exchanges. These companies must comply with the different accounting rules and standards applicable in countries in which they operate, which makes their financial reporting increasingly difficult and costly.
(3) Groups making efforts to harmonize accounting standards and company-law in connection with a greater economic and political integration of a given geographic area, *e.g.*, the EEC.
(4) Other national interest groups in various countries who are primarily interested in more stringent reporting requirements for international companies, with the objective of exercising more control over multinational companies.

As you can see from the background material that I have included as an Appendix to this Chapter, there are basically two different types of international organizations working to harmonize accounting standards. First, there are the bodies organized by governments, such as the United Nations, the OECD, and the EEC. Second, there are the international organizations set up by independent professional accounting bodies, such as the International Accounting Standards Committee and the International Federation of Accountants.

I would like to concentrate for the next few moments on the efforts of, and problems encountered by, the two organizations that have so far produced the most tangible results: the EEC and the International Accounting Standards Committee.

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2. THE EUROPEAN ECONOMIC COMMUNITY [EEC]

The EEC is striving to create a common market with a free flow of capital, labor, and merchandise within its boundaries. In that context, company-law is being harmonized, and this involves harmonization of company financial reporting. The vehicles for harmonization are directives issued by the Council of Ministers to be incorporated in national laws of the member states. The Fourth Directive (on company accounts) was promulgated in 1978, and the Seventh Directive (on consolidated accounts) is in preparation. These directives have a significant impact on company reporting in the member states (the Fourth Directive will affect more than 1.5 million companies) and they are a considerable contribution to harmonization within, and probably outside, the EEC.

At the same time, the directives demonstrate the difficulties encountered in the harmonization process. It took more than ten years from the time that the Fourth Directive was first conceived to its final approval. In order to achieve agreement between member states on a number of issues, options had to be allowed to member states in enacting their national legislation, and also certain options were left to companies. With such wide latitude given, the Fourth Directive is more of a guideline than an agreed standard. The directive had to accept the fact that in some member states, financial statements are influenced by tax considerations, since in those countries taxation is based on statutory accounts. Furthermore, the Fourth Directive does not deal with all accounting issues, especially in the field of measurement. For example, there is nothing specific in it on translation of foreign currencies, on accounting for the effects of changing prices, or on deferred taxation.

It is expected that with the passage of time the gaps will be filled and the options will gradually be reduced. For the time being, however, financial statements of companies operating in different countries in Europe will still differ significantly. As an example, the proposed new national accounting legislation in Germany, resulting from the Fourth Directive, is likely to leave German companies out of line with other European and international practices in several key areas. (1) German company accounts will continue to incorporate tax-based rather than commercial valuations. (2) Consolidation will continue to be required on a domestic basis only, although this will change when legislation to comply with the EEC's Seventh Directive is introduced. (3) It is expected that Germany will continue to adopt a hostile approach to any form of accounting for changing prices, and the government will not propose the enabling legislation which would make inflation accounting compatible with the Fourth Directive.

3. INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE [IASC]

Compared to the EEC the IASC has undertaken an even bigger task--the harmonization of accounting standards on a *worldwide* basis. The IASC was formed in 1973 by the leading accounting bodies of ten countries: Australia, Canada, France, Germany, Japan, Mexico, The Netherlands, the U.K., Ireland, and the U.S. Today it represents fifty-nine professional accounting bodies in forty-seven countries. Its objectives are "to formulate and publish, in the public interest, standards to be observed in the presentation of audited financial statements and to promote their worldwide acceptance."

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So far the IASC has issued thirteen Accounting Standards and six Exposure Drafts. A number of additional topics are presently under study. The standards are similar in format to the pronouncements issued by the Financial Accounting Standards Board [FASB] here in the U.S., and they cover topics such as inventories, consolidation, contingencies, and income taxes. Due to the variety of accepted accounting treatments worldwide, the international standards are, in general, broadly phrased and they allow options, *i.e.*, different treatments for the same type of transactions.

Options are considered necessary in order to account for differences in economic conditions and for differences in national objectives for financial reporting around the world. Obviously, when options are allowed they reduce the degree of uniformity in financial reporting. As a result, the International Accounting Standards [IAS] represent an attempt to find common ground among national standards in areas where the standards of reporting are already highly developed, as opposed to an effort to standardize financial reporting. The degree of harmonization greatly depends on the degree of compliance with the IAS.

In this regard it is important to consider the authority of the IAS. Within each country local regulations govern, to a greater or lesser degree, the issue of financial statements. The IAS promulgated by the IASC do not override these local regulations. The IASC pronouncements are somewhat in the nature of recommendations and lack direct or supranational authority.

It was realized when the IASC was established that the IAS could not be imposed with the authority of law or of professional requirements; but it was hoped that compliance could be achieved by IASC member bodies influencing the business community. IASC member bodies committed themselves to the support of the IAS, to the use of their best endeavors in persuading all parties concerned that financial statements should comply with international standards, and to the requirement that auditors report non-compliance in their opinions. It now appears that these pressures are insufficient. The IASC has realized that compliance with its standards is, in fact, poor.

There are a number of reasons for these unsatisfactory results. In some countries the profession is not, or is no longer, in control of the standard-setting process--the FASB for example is not a member of the IASC. In other countries the professional body has no power to prescribe what auditors should state in their opinion; and in yet other countries, auditors are not allowed to say anything in their opinions beyond what is required by law. So the road is obviously more difficult than it was thought to be in 1973.

In an effort to improve its standing and to increase the level of compliance with its pronouncements, the IASC has approached the U.N. and the OECD with a suggestion for greater cooperation in the area of standard setting. In addition, the IASC is trying to increase its liaison with national standard-setting bodies, and it is calling on business interests, in particular the international and multinational companies, to give more support to the work of the IASC by making reference to compliance with the IAS in their annual reports.

One result of the IASC's work which should be mentioned is that many developing countries that have no established profession and no standards of their own are adopting the IAS as a national standard. The harmonization of accounting standards in these areas

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is a significant step forward, but in the final analysis, full compliance with the IAS can be achived only if (1) the various professional bodies in the industrialized countries of the world give active support to the quest for international harmonization of accounting standards, (2) governments support the recommendations of the professional bodies and initiate the necessary legal changes, and last but not least, (3) the IAS enjoy the support of the international business community.

4. FOREIGN CURRENCY TRANSLATION

I have identified certain of the efforts made so far and the problems encountered by some of the organizations active in harmonizing accounting standards. Next, I would like to discuss the latest developments and some open questions relating to an important and controversial accounting issue: foreign currency translation.

Recent developments concerning foreign currency translation can serve as a good example of a truly international effort to speed up the harmonization process in a controversial area. In the U.S., the FASB has had its statement FASB No. 8 under review for the past two years. Since FASB No. 8 was issued in 1975, the statement has been criticized both by management of U.S. companies and by the accounting profession. Although some accountants believe FASB No. 8 is technically sound, many believe it produces unrealistic results.

Without going into technical details, FASB No. 8 is based on the temporal method, which uses a mixture of historical and current exchange rates for the translation of assets, liabilities, income, and expense items of foreign-based operations. The underlying assumption for the use of a mixture of exchange rates is that the unit of measurement for the performance of foreign-based operations is the currency of the ultimate reporting entity, *i.e.*, the U.S. dollar. As a result, in times of widely fluctuating exchange rates the performance of a foreign-based operation measured in U.S. dollars may show unsatisfactory results, although the performance reflected in the local (foreign) currency financial statements is exceptionally good--or vice versa.

During the time the FASB had its statement No. 8 under reconsideration, the U.K. and Canadian institutes were also considering the issuance of standards on the subject. In 1980 a number of meetings were held among the FASB and the U.K. and Canadian institutes in order to exchange views on developments in each country and to explore ways to achieve a degree of harmonization in the standards to be published in each country. These meetings and what followed marked a significant step forward toward achieving international harmonization. It was the first time, to my knowledge, that the standard-setting bodies of these three countries (as contrasted with the IASC) had met with the objective of arriving at a common standard.

The exposure drafts that were issued by the FASB and the U.K. Accounting Standards Committee in October 1980 demonstrated this intention to agree. These two proposals are considered to be similar in all important aspects, although there are some material differences in the exceptions provided by the two drafts. Both drafts require the current-rate method; and for the U.S. this would be a revolutionary change from the presently applicable temporal method under FASB No. 8.

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Canada and Ireland are presently holding back on issuance of standards, awaiting the outcome of these proposals in the U.S. and the U.K. Should the U.S. and U.K. approve the proposed statements, the current-rate method would, in all probability, also be used by other countries influenced by the U.K. and the U.S.

5. THE INTERNATIONAL ACCOUNTING FIRMS

I shall close with a few remarks about the *modus operandi* of the major international accounting firms and about the role they can play in the process of harmonizing accounting standards. With their experience in the multinational environment, members of these firms can and do make significant contributions, either by participating in or by commenting on the work of various organizations active in the field of harmonization. In order to maintain a high professional standard throughout their worldwide practice, these firms encourage their clients to adopt the highest standards for accounting and reporting procedures in their financial statements. In certain areas or countries where such standards are not stringent, however, the influence of the international accounting firms is limited.

The international financial press has suggested that international firms should contribute to the upgrading of accounting and reporting standards by not allowing their names to be associated, without qualification, with financial statements that do not meet certain minimum standards. In my view this suggestion is not feasible or practical because the firms cannot and should not attempt to move themselves into a quasi standard-setting position. Setting of standards is clearly the responsibility of the professional or governmental accounting bodies in the various countries--not that of the accounting firms themselves.

Furthermore, international firms cannot easily step out of line with the legal and professional requirements of the country where the financial statements are being drawn up. They are bound to observe the accounting and reporting standards required in each country. Where there is an established local profession, the international firms are normally members of this group, and they must follow its conventions. A deterioration in relations with the local profession could result in jeopardizing a firm's right to practice in the country or to practice in its own name.

The international firms can and will continue to make their contributions to the harmonization process by participating in various organizations, by rendering their professional expertise, and by using their best efforts to encourage their clients to do more on a voluntary basis.

MR. HAWES: The New York Stock Exchange says there are three hundred companies worldwide that would comply with its alternate listing standards. Using those standards, would investors (and I am talking of sophisticated analysts) have a problem comparing those three hundred companies today--any significant problem?

MR. HERBERT: If those companies are audited by what I refer to as one of the major international firms, the investors would not have a problem. I am not denigrating my professional colleagues in other countries. We have different standards; it is as simple as that. But if the audit is performed according to some local account-

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ing systems in those foreign countries, I strongly suggest that investors should look very, very carefully at what is taking place.

Let me give you an example, without naming the country because their representative is here and I do not want to get in any trouble. We want to continue our practice in that country. A very, very major company--by any standard--employed us to perform an audit in one of the highly industrialized countries of the world because they were considering issuing securities through the Frankfurt market. We spent an enormous amount of time trying to do this engagement.

We came down to a relatively simple item called depreciation and we said, "Fellows, you have to take depreciation. That is the name of the game."

And they said, "Well, we had a bad year. Next year we are going to have a terrific year, and then you can take five times as much depreciation, but you cannot take it this year."

Now, I am not kidding when I tell you that we spent over seventy hours in partner time with the top management of this firm, trying to convince them that they had to take depreciation. In the final analysis we said, "If we cannot do it, then we are going to back off this engagement. We will not go ahead." That is the only way we got it done.

These were highly sophisticated businessmen in their own community. They truly believed what they said, because that is the way it is done locally. They thought we were out of our minds, telling them that they must further depress earnings by putting in this crazy thing called depreciation.

MR. HAWES: We will let Steve Friedman have the next question.

MR. FRIEDMAN: Granted the problems with harmonization, is there a middle ground that would make financial statements prepared in different countries with somewhat different conceptual systems useful to investors without a full re-statement? Is there a way to develop an explanation of differences in accounting treatment that would help investors interpret financial statements prepared in a different system, or are we on a thousand year journey?

MR. HERBERT: It may not be a thousand years, but it is a long journey. The IASC is trying to do what you are describing. But think about it in reverse. Think about explaining LIFO inventories and its ramifications to people in a foreign country who never heard of LIFO and do not have the slightest clue as to what LIFO means. That is a difficult task. The financial press would say it is simple: you can easily explain a thing like that. I very much disagree with their position. But to answer your question directly, I think what you have described--that middle ground--is the best we can hope for in any short-range period.

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APPENDIX XIII-A

ORGANIZATIONS ACTIVE IN SETTING INTERNATIONAL ACCOUNTING STANDARDS

United Nations (UN)

For many years the UN has been active in the field of international accounting. An intergovernmental working group of experts was established in May 1979. This group is composed of 34 representatives from the following areas: African States, 9 members; Asian States, 7 members; Latin American States, 6 members; Western European and Other States (including the United States), 9 members; and Eastern European States, 3 members. The group was directed to research further steps to be taken in the field of international standards of accounting and reporting and to formulate priorities. A report to the Commission on Transnational Corporations is due in May 1981.

Organization for Economic Cooperation and Development (OECD)

The OECD, which is based in Paris, is the world's largest group of industrialized countries and comprises 19 European countries, the United States, Canada, Japan, Australia, and New Zealand. Participation in this organization is restricted to government representatives.

Based on the recommendations of a previous *ad hoc* working group, the OECD Committee on International Investment and Multinational Enterprises established an apparently permanent working group on accounting standards. International business and labor interests, the IASC, and the Group of European Accountants are asked to participate in the work of this working group through regular consultations. The objective of this group is to seek ways to energize existing activities in setting international accounting standards.

European Economic Community (EEC)

Based on a statement of the Council of Ministers of the EEC, one of the aims of the common market's industrial policy is the creation of a unified business environment. This involves the harmonization of company law and taxation, and the creation of a community capital market. The Fourth Directive of the EEC Commission provides the framework for a common standard of accounting and reporting. It requires adoption by the EEC member countries by 1982.

A revised Seventh Directive dealing with consolidated financial statements was recently proposed. Approval of this Directive by the Commission is expected in 1981.

African Accounting Council (AAC)

The AAC was formed by 27 African countries in June 1979. Its objectives are to assist in the establishment of bodies entrusted with accounting standardization in African countries and to promote and carry out studies in the field of accounting standardization. This organization is still in the formative stage.

Asian Federation of Accountants (AFA)

The AFA was formed during 1977 jointly by the accountancy bodies of Indonesia, Malaysia, the Philippines, Singapore, and Thailand. The objective of this organization is to improve professional standards in South East Asia. In 1979 the first in a series of accounting standards was issued by the Federation. These standards deal with fundamental accounting principles.

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International Federation of Accountants (IFAC)

The IFAC is an organization of world accountancy bodies engaged in developing international auditing, educational, and ethical guidelines. International accounting standards are now issued by the International Accounting Standards Committee (IASC), an organization independent of the IFAC. There is a possibility that IFAC and the IASC may merge and it is for this reason that IFAC is included in this summary.

IFAC was formed in 1977 and started its operations in 1978. At January 1981, the membership of IFAC comprised 76 accountancy bodies in 58 countries. The Federation has formed committees on the subjects of auditing, education, ethics, management accounting, planning, regional organizations, and a committee to organize the 1982 International Congress in Mexico. The Auditing Practices Committee of the Federation has been authorized by the Council to issue guidelines on international auditing matters.

International Accounting Standards Committee (IASC)

The IASC was formed in 1973 by the leading accounting bodies of Australia, Canada, France, Germany, Japan, Mexico, The Netherlands, the United Kingdom and Ireland, and the United States. The Committee represents 59 professional accountancy bodies in 47 countries. Its business is conducted by a board consisting of two representatives of each of the nine founder members and two representatives each from not more than two other member bodies. The IASC has the responsibility and authority to issue, in its own name, pronouncements on International Accounting Standards.

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APPENDIX XIII-B

SUMMARY OF STATEMENTS OF INTERNATIONAL ACCOUNTING STANDARDS AND EXPOSURE DRAFTS ISSUED BY THE IASC AS OF JANUARY 1, 1981

International Accounting Standards

1. Disclosure of accounting policies
2. Valuation and presentation of inventories in the context of the historical cost system
3. Consolidated financial statements
4. Depreciation accounting
5. Information to be disclosed in financial statements
6. Accounting responses to changing prices
7. Statement of changes in financial position
8. Unusual and prior period items and changes in accounting policies
9. Accounting for research and development activities
10. Contingencies and events occurring after the balance sheet date
11. Accounting for construction contracts
12. Accounting for taxes on income
13. Presentation of current assets and current liabilities

Exposure Drafts

14. Accounting for foreign transactions and translation of foreign financial statements
15. Reporting financial information by segment
16. Accounting for retirement benefits in the financial statements of employers
17. Information reflecting the effects of changing prices
18. Accounting for property, plant and equipment in the context of the historical cost system
19. Accounting for leases

Other Topics Under Consideration

The following additional topics are presently under study by the IASC. Exposure drafts have, however, not yet been issued on these subjects.

Accounting for Business Combinations
Revenue Recognition
Accounting for Interest Costs
Disclosures in Financial Statements of Banks
(Discussion paper issued)
Accounting for Government Grants
Related Party Transactions

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APPENDIX XIII-C

COMPARISON OF INTERNATIONAL ACCOUNTING STANDARDS WITH ACCOUNTING RULES AND PRINCIPLES APPLICABLE IN CERTAIN MAJOR PRACTICE AREAS AROUND THE WORLD

The following comparison has been prepared in order to identify controversial issues between the IAS and local rules and principles. It has been restricted to situations in which financial statements prepared in accordance with local rules and principles conflict with certain provisions of the IAS.

	International Accounting Standard Subject Matter	Controversial Issues	Accounting Principles Generally Accepted in the United States	Standard Accounting Practice in the United Kingdom
1	Disclosure of Accounting Policies	IAS No.1 requires presentation of comparative financial statements	Presentation of comparative financial statements required for public companies (SEC regulations) *not* required for private companies	Presentation of comparative financial statements *also* required
2	Valuation and presentation of inventories in the context of the historical cost system	IAS No.2 requires valuation of inventories at the lower cost and net realizable value	Require valuation of inventories at the lower of cost or current replacement cost provided current replacement cost is not in excess of net realizable value or below net realizable value reduced by the approximate normal profit margin. (In addition U.S. GAAP permit valuation of certain inventories above cost.)	Valuation at the lower of cost and net realizable value *also* required

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Provisions of the Fourth Directive of the European Economic Community	Accounting Standards in Australia	Accounting Principles Generally Accepted in Canada	Accounting Practice Generally Accepted in the Republic of South Africa
Presentation of comparative financial statements *also* required	Presentation of comparative financial statements *also* required	Presentation of comparative financial statements *also* required	Presentation of comparative financial statements *also* required
Requires valuation at the lower of cost or market. It is assumed that market can be interpreted as both current replacement cost or net realizable value. Disclosure is required in notes to financial statements of difference between inventory value stated in balance sheet and current replacement cost at balance sheet date, if significant. (In addition Fourth Directive permits valuation of inventories below cost or market, if value is acceptable for tax purposes. Disclosure of difference required in notes to financial statements.)	Valuation at lower of cost and net realizable value *also* required	Valuation at the lower of cost or market is most common practice (Significance of differences between IAS No.2 and Canadian GAAP is presently under study by the Canadian Accounting Research Committee.)	Requires valuation of inventories at the lower of cost or net realizable value or replacement cost or other expressly specified value. (Exposure draft issued *proposes* valuation at the lower of cost or net realizable value.)

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International Accounting Standard Subject Matter	Controversial Issues	Accounting Principles Generally Accepted in the United States	Standard Accounting Practice in the United Kingdom
3 Consolidated Financial Statements	IAS No. 3 *permits* consolidation in the following cases:		
	"holding company" owns majority of equity capital but less than half of voting stock.	Consolidation *not* permitted	Consolidation *not* permitted
	"holding company" has the power to control by statute or agreement with or without more than half of the equity interest.	Consolidation *not* permitted without ownership of more than half of the equity interest.	Consolidation *required* if control is exercised by the power to nominate a majority of the board of directors.
	IAS No. 3 *requires* disclosure of proportion of assets and liabilities to which different accounting principles have been applied, if they are included in a single balance sheet classification.	Disclosure of proportion of assets and liabilities to which different accounting principles have been applied, if they are included in a single balance sheet classification, *not* required.	Disclosure of proportion of assets and liabilities to which different accounting principles have been applied, if they are included in a single balance sheet classification *also* required.
	IAS No. 3 *requires* equity accounting for certain investment accounts.	Equity accounting *also* required.	Equity accounting *also* required.

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Provisions of the Fourth Directive of the European Economic Community	Accounting Standards in Australia	Accounting Principles Generally Accepted in Canada	Accounting Practice Generally Accepted in the Republic of South Africa
Consolidation not dealt with in Fourth Directive. Subject matter of proposed Seventh Directive			
Consolidation *also* permitted (Proposed 7th Directive)	Consolidation *also* permitted	Consolidation *not* permitted	Consolidation *required* (matter under consideration for issue of exposure draft)
Consolidation *also* permitted (Proposed 7th Directive)	Consolidation *required* if control can be exercised. Control is a question of fact *not* prescribed through legal rules	Consolidation *not* permitted	Consolidation *required* if holding company or one of its subsidiaries is a member of that other company *and* controls the composition of the board of directors.
Financial statements of all companies included in consolidation are required to be *uniformly* prepared in accordance with provisions of 4th Directive (Proposed 7th Directive)	Disclosure of proportion of assets and liabilities to which different accounting principles have been applied, if they are included in a single balance sheet classification, *not* required	Disclosure of proportion of assets and liabilities to which different accounting principles have been applied, if they are included in a single balance sheet classification, *not* required	Matter not ruled upon
Equity accounting optional; *not* required (Proposed 7th Directive, if adopted, will *also* require equity accounting)	Matter not ruled upon. (Equity accounting is, however, *permitted)*	Equity accounting *also* required	Matter not ruled upon. (Equity accounting is, however, *permitted)*.

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	International Accounting Standard Subject Matter	Controversial Issues	Accounting Principles Generally Accepted in the United States	Standard Accounting Practice in the United Kingdom
4	Depreciation Accounting	IAS No. 4 requires disclosure of certain information including the useful lives or depreciation expense for the period and accumulated depreciation *individually for each major class of depreciable asset.*	Disclosure of such information *not* required individually for each major class of depreciable asset	Disclosure *also* required individually for each major class of depreciable asset (In addition disclosure is required of all movements during the year for individual classes of fixed assets.)
7	Statement of Changes in Financial Position	IAS No. 7 requires the presentation of a statement of changes in financial position.	Presentation of a statement of changes in financial position *also* required	Presentation of a statement of changes in financial position *also* required

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Provisions of the Fourth Directive of the European Economic Community	Accounting Standards in Australia	Accounting Principles Generally Accepted in Canada	Accounting Practice Generally Accepted in the Republic of South Africa
Disclosure of estimated useful lives or depreciation rates *not* required individually for each major class of depreciable asset (In addition disclosure is required of all movements during the year for individual classes of fixed assets.)	Disclosure of such information (except for estimated useful lives) *also* required individually for each major class of depreciable asset	Disclosure of such information *not* required individually for each major class of depreciable asset	Disclosure of such information *not* required individually for each major class of depreciable asset. (Exposure draft issued *proposes* disclosure of such information individually for each major class of depreciable asset.)
Presentation of a statement of changes in financial position *not* required	Presentation of a statement of changes in financial position *only required* for companies with shares listed on an Australian stock exchange.	Presentation of a statement of changes in financial position *also* required	Presentation of a statement of changes in financial position *also* required

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International Accounting Standard Subject Matter	Controversial Issues	Accounting Principles Generally Accepted in the United States	Standard Accounting Practice in the United Kingdom
9 Accounting for Research and Development Activities	IAS No. 9 requires all *research costs* to be charged as an expense in the period incurred.	*Also* require that all research costs are charged as an expense in the period incurred	*Also* requires that all research costs are charged as an expense in the period incurred
	IAS No. 9 in principle also requires *development costs* to be charged to expense in the period incurred but allows the deferral and systematic amortization of certain development costs if a number of specified criteria are met.	Require that all development costs are charged as an expense as incurred. Do *not* allow deferral of certain development costs	In principle *also* requires that development costs are charged to expense as incurred *but* allows the deferral and systematic amortization of certain development costs if a number of specific criteria similar to those of IAS No. 9 are met
	IAS No. 9 requires disclosure of the total of research and development costs charged to expense.	Disclosure of total research and development cost charged to expense *also* required	Disclosure of total research and development cost charged to expense *not* required. Only disclosure of movements in deferred development cost is required

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Provisions of the Fourth Directive of the European Economic Community	Accounting Standards in Australia	Accounting Principles Generally Accepted in Canada	Accounting Practice Generally Accepted in the Republic of South Africa
Provide that research *and* development costs are expensed, or, insofar as national law permits, may be deferred and amortized over a maximum period of 5 years.	Australian rules on accounting for research and development cost are only recommendations *not* an accounting standard	*Also* require that all research costs are charged as an expense in the period incurred	Matter not ruled upon
In the case of a deferral, the company is only permitted to distribute the income to the extent that accumulated retained earnings are in excess of the amounts of deferred research and development costs shown in the balance sheet. In exceptional cases member states may permit departure from the rules regarding the 5 year amortization period and the retained earnings retention.	Rules allow deferral of research and development cost where it can be clearly identified as contributing to the revenue-earning capabilities of the business in the future and amounts deferred will be absorbed by future revenues, or if capitalized, would at least realize their book value on disposal.	Require that all development costs are charged to expense as incurred *except* in circumstances where specified criteria are satisfied. Where specified criteria are satisfied, deferral and amortization on a systematic and rational basis are *required*.	Matter not ruled upon (Present practice is to either defer research and development costs or expense as incurred)
Disclosure of total research and development cost charged to expense *also* required	Matter not ruled upon.	Disclosure of total research and development cost charged to expense *also* required	Matter not ruled upon

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International Accounting Standard Subject Matter	Controversial Issues	Accounting Principles Generally Accepted in the United States	Standard Accounting Practice in the United Kingdom
12 Accounting for Taxes on Income	IAS No. 12 provides that the full comprehensive method of tax allocation, i.e., deferred tax accounting, should *normally* be applied.	Comprehensive method of tax allocation, i.e., deferred tax accounting, is *required*	*Also* provides that comprehensive method of tax allocation, i.e., deferred tax accounting, should *normally* be used
	IAS No. 12 permits that the partial approach of deferred tax accounting may be applied when there is reasonable evidence that: timing differences will not reverse for some considerable period (at least 3 years) *and* there is no indication that the timing differences are likely to reverse after that period.	Partial approach of deferred tax accounting *not* permitted	*Requires* adoption of the partial approach to deferred tax accounting, if criteria for the application of the partial approach (same as under IAS No. 12) are met.
	IAS No. 12 provides that either the deferral or the liability method be used for the calculation of deferred taxes.	Deferral method is *required*. The liability method is not acceptable.	Liability method *presumed* but by implication deferral method also allowed.

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Provisions of the Fourth Directive of the European Economic Community	Accounting Standards in Australia	Accounting Principles Generally Accepted in Canada	Accounting Practice Generally Accepted in the Republic of South Africa
Application of deferred tax accounting *optional*. However, disclosure of unrecorded deferred tax credits or debits, if material, is required in the notes to financial statements.	Comprehensive method of tax allocation, i.e., deferred tax accounting, is *required*	Comprehensive method of tax allocation, i.e., deferred tax accounting, is *required*	Comprehensive method of tax allocation, i.e., deferred tax accounting, is *required*
Matters not ruled upon	Partial approach of deferred tax accounting *not* permitted	Partial approach of deferred tax accounting *not* permitted	Partial approach of deferred tax accounting *not* permitted
Matters not ruled upon.	Liability method is *required*. Deferral method is not acceptable.	Deferral method is *required*. The liability method is not acceptable.	*Also* provides that either the deferral or the liability method be used.

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INTERNATIONAL SECURITIES MARKETS: COMPARATIVE DISCLOSURE REQUIREMENTS

Robert C. Pozen

MR. HAWES: Continuing our previous theme, the special legal and accounting problems in multinational activity, we now take on the other half of the disclosure question--the legal concepts. Bob Pozen will talk primarily about other disclosure aspects and the international developments in that area.

MR. POZEN: We should begin by recognizing that the disclosure requirements in the U.S. are higher (or some would say more burdensome) than the disclosure requirements in most other countries, with a few exceptions which I will touch upon later. Thus, as a practical matter when we talk about the international harmonization of disclosure requirements, there are really only two possibilities: first is that the U.S. will make some accommodations in its disclosure requirements; and second is that other countries will significantly increase their disclosure requirements.

1. RECENT HARMONIZATION INITIATIVES IN THE U.S.

Let us begin by looking at the SEC's willingness to make accommodations in U.S. disclosure requirements for foreign issuers. Within the last few years, the SEC has shown considerable flexibility in this area. As many of you know, in Form 20-F the SEC evolved new standards for annual reporting by foreign issuers [1]. In so doing, the SEC made four main accommodations for foreign issuers.

A. SEC Form 20-F

The first is allowing foreign issuers to use their own financial statements, but then requiring them to disclose the material differences between those financial statements and generally accepted accounting principles [GAAP], if any. This goes to what Steve Friedman was suggesting. The SEC has stated that it is not going to require, at least in Form 20-F, every foreign issuer to use GAAP; rather, such issuers can use whatever financial statements they want and then explain as clearly as possible any material differences.

A second major innovation in Form 20-F was on segment reporting, where the SEC allowed a modified version of segment reporting by foreign issuers--on a revenue basis only--plus a discussion of any material difference in the respective contributions of profits and revenues by segment. This recognized that in most countries the type of segment reporting we have in the U.S. is not required.

A third area of accommodation in Form 20-F was management remuneration. There the SEC allowed aggregated disclosure rather than the type of detailed disclosure for individual executives that is required for executives of American issuers [2].

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The fourth main area was interested transactions. There the SEC said, basically, that a foreign issuer must disclose to the SEC what it is required to disclose by foreign law or exchange rules or otherwise. But if it is not required to disclose very much by those other rules, the SEC will not independently require that the foreign issuer follow the disclosure rules on interested transactions that apply to American domestic issuers.

B. 1933 Act Disclosure

More recently than Form 20-F--in the ABC release [3] and the other releases that are part of the integration program--the SEC has begun what is probably an even more important look at foreign issuers, from the viewpoint of disclosure requirements of the Securities Act of 1933. While 20-F, in addition to being an annual report form, is called a registration form, this is somewhat misleading. In fact 20-F is only a registration form under the Securities Exchange Act of 1934 with respect to listing on an exchange. When most of us think of registration forms, we think of registration forms for 1933 Act filings. If special 1933 Act registration forms for foreign issuers are to be adopted, they will be developed as an outgrowth of these integration releases.

The SEC has historically taken a somewhat stricter view towards disclosure in the 1933 Act context than in the 1934 Act context, on the theory that the 1933 Act filing is a very special event on which investors will focus. But it is probably true that the 1934 Act disclosure documents, such as Form 20-F, have a greater impact on investors than the 1933 Act documents. The 1934 Act documents, the annual and periodic reports, affect all the trading in a stock over a significant period of time, while the 1933 Act disclosure documents affect only the people who are buying in that particular offering or trading during a very limited time period. Thus, it is hoped that the SEC will use the four accommodations in Form 20-F that I just mentioned as models for similar accommodations in the forms that are evolved under the 1933 Act for foreign issuers.

As part of the same ABC release, the SEC will be deciding in which situations Form A can be used by foreign issuers . Form A is going to be the approximate equivalent of the existing Form S-16 and will allow a high degree of incorporation by reference rather than require additional disclosures in the prospectus.

In the ABC release, the SEC suggested that Form A will be available to any foreign issuer that voluntarily files 10-Ks, 8-Ks, and all other disclosure documents that American issuers are filing. It seems clear that if a foreign issuer voluntarily files the same reports as a domestic issuer, the foreign issuer should be entitled to use Form A on the same terms as a domestic issuer. However, that is a somewhat limited approach and the SEC should be willing to go further. Most important, those foreign issuers that are now filing Form 20-F should be able to piggyback the Form 20-F in 1933 Act filings, just as the domestic issuers will be piggybacking 10-Ks in their 1933 Act filings. As long as the foreign issuer is actively traded on an exchange or on NASDAQ, it should be receiving a high degree of exposure and investor attention. If the SEC accepts the basic principles of the efficient markets theory, which underlies the integration approach, the SEC should be willing to require less in the way of 1933 Act documents for foreign issuers that are actively trading on well developed markets and filing Form 20-Fs.

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C. Shelf Registration

Another important development at the SEC, which has not received as much attention as the ABC release, is the SEC's proposal on shelf registration. This is contained in proposed Rule 462A [4]. It is tucked away in the proposals for revisions to the disclosure guides that were issued during the last few months. The proposal on its face would allow private foreign issuers as well as foreign governmental issuers to use shelf registration. This would be an extremely useful development for foreign issuers which, as discussed by previous speakers, face very fast-moving time constraints.

As proposed, shelf registration would be available to foreign issuers even if they have not yet begun to trade actively in the U.S. I hope the SEC will continue to take a liberal view towards that group of foreign issuers; at the very least, the SEC should recognize that there are a number of foreign issuers that are larger than foreign governments which are now allowed to use shelf registration [5]. Although such large foreign issuers may not yet have traded in the U.S., they should be given some preferential treatment because of the likelihood that their securities are followed in the U.S. and that there is fairly decent disclosure about their activities already available in the marketplace.

2. INCREASE IN DISCLOSURE STANDARDS ABROAD

A. Sixth Directive of the EEC

Turning to the second possible approach--that is, reaching harmonization through an increase in disclosure standards of other countries--the most significant development within the last few years has been the adoption of the Sixth Directive by the European Economic Community. This directive applies to initial offerings of securities that are immediately thereafter listed on exchanges in the EEC [6].

In Appendix XIV-A at the end of this Chapter, there is a detailed comparison of the Form 20-F requirements with the EEC requirements in the Sixth Directive. What is striking is the large number of similarities between these two sets of requirements. If other countries move toward the requirements of Form 20-F and the EEC's Sixth Directive, there would be a tremendous narrowing of the significant differences in international disclosure requirements.

B. Proposed EEC Directive on Disclosures to Employees

Indeed, in one area of disclosure the EEC is considering much more extensive requirements than those of the SEC: disclosures relating to the interests of employees as opposed to stockholders. Appendix XIV-C comprises a recent EEC proposal that would require semi-annual reporting of multinational firms--including American-based firms with subsidiaries in the EEC--to employees on a broad range of subjects [7]. There is an especially interesting proposal with regard to the duty of the firm to inform employees forty days in advance of any decision to merge or sell all its assets. The proposal contemplates that if there is a "substantial effect on the interests of its workers," they will have the opportunity to consult and meet with management.

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It is unclear, however, what happens after workers and management meet if they do not reach an agreement. This proposal, I should add, has been severely criticized by some international groups, including the International Chamber of Commerce; and it is by no means certain that it will be adopted. But I think it is an important disclosure proposal worthy of attention and study.

C. Minimum Standards

There have also been other attempts to evolve certain universal or international disclosure standards. These have occurred at the United Nations and at other international institutions. Most of these attempts have been aimed at establishing what I would call minimum standards: that is, every country should refuse to allow any issuer to list or offer securities unless specified minimum standards are met.

In my view, however, the minimum standard approach seems misguided. In essence, minimum standards threaten to drive small and medium sized companies out of domestic markets. If minimum standards are set at levels that are reasonable from the viewpoint of an international securities market, countries may find that most of their small and medium sized issuers do not meet these standards. But these issuers are not the ones that have any interest in using the international securities markets. Therefore, it seems misguided to evolve minimum international standards where the issuers primarily affected are those without any role in the international securities market.

D. World Class Securities

I suggest that in the future we try to aim any international standards at the much more limited class of issuers with an interest in, and a possibility of going into, the international securities markets [8]. In that regard, we might designate a subcategory of issuers as world class issuers, and we could spend some time thinking about what should be the appropriate standards for designating companies as belonging to that class. For example, what should be the appropriate number of shareholders? How closely should these issuers be follwed by analysts? What types of reports should they be making, and to whom?

If we evolve standards for identifying world class issuers, we would in effect be saying that this class of very large, well seasoned, and closely followed companies should automatically be listed on any exchange in the world and should have available to it a very short form registration for primary offerings in any market. It would be much more fruitful to focus on this class of internationally interested issuers and to help them go in and out of all the different markets in the world than to set up minimum standards that actually affect issuers with no international interest.

But I would hasten to add that if we move toward the concept of world class securities, and if certain issuers have securities traded on markets in a number of countries, we would then run into a number of practical and regulatory problems associated with trading in multiple markets--like the problems in the U.S. caused by certain securities being traded on regional markets and also in New York. If we had a truly international securities market in which the same security is traded in five different countries, we would have to deal

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with problems like best execution. Since we have struggled so long with best execution in the U.S., we can just imagine how much more difficult this problem would be on a worldwide basis. I think some of the other speakers will address the problems that have already developed as a result of multiple markets in the international securities area.

NOTES

[1] Securities Exchange Act Release No. 16,371, 44 Fed. Reg. 70,132 (1979).

[2] *See also* Securities Act Release No. 6157, 44 Fed. Reg. 70,130 (1979).

[3] Securities Act Release No. 6235, 45 Fed. Reg. 63,693 (1980). The SEC recently issued another series of releases dealing with disclosure integration which, among other things, reproposed three basic 1933 Act registration statement forms, now designated Forms S-1, S-2 and S-3. *See* Securities Act Release Nos. 6331-6338, 46 Fed. Reg. 41,901-42,057 (1981).

[4] Securities Act Release No. 6276, 46 Fed. Reg. 78 (1981). Rule 462A was recently reproposed in Securities Act Release No. 6334, 46 Fed. Reg. 42,001 (1981).

[5] Securities Act Release No. 6240, 45 Fed. Reg. 61,609 (1980).

[6] 80/390/EEC, OJ No. L 100, 17.4.80. On January 13, 1981, a proposed directive was issued concerning the requirements for a prospectus to be published when securities are offered for subscription or sale to the public, OJ No. C 355, 31.12.80, p. 39. The disclosure requirements contained in this proposal are, in general, equivalent to those contained in the Sixth Directive.

[7] EEC Commission, Proposal for Informing and Consulting the Employees of Undertakings with Complex Structures in Particular Transnational Undertakings (Oct. 1, 1980), *infra* at 218. This proposed directive is known as the Vredeling Proposal.

[8] *See* Pozen, *Disclosure and Trading in an International Securities Market,* 15 Int. Lawyer 84 (1981).

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APPENDIX XIV-A

Author: Douglas W. Hawes

COMPARISON OF SUBSTANTIVE PROVISIONS OF SEC FORM 20-F & THE EEC's SIXTH DIRECTIVE
ANNEXES A (SHARES) AND B (DEBT)

*Indicates Same Provision in Annex B, Usually with Same Number

Form 20-F		Sixth Directive
Cover Page		
a) Name	A 311*	Name
b) Jurisdiction of Incorporation	A 314a*	Registry Number
	A 313*	Legislation under which company operates and legal form
c) Address of Principal Executive Office	A 311	Registered office and principal administrative establishment, if different
d) Title of Class of Securities Registered	A 21	Indication whether shares are already public
	A 22	Information concerning shares
	A 221	Nature of the issue and amount thereof and resolutions relative thereto
	A 241	Description of shares
e) Exchange on which Registered, if any	A 225*	Stock exchange or exchanges on which admission is or will be sought (see also A 21)
	A 244*	Stock exchanges on which already listed or
	A 245*	traded but not listed
Page 2		
a) Indicate number of outstanding shares of each of the issuer's classes of stock	A 32	Capital
	A 321*	Amount of subscribed capital
	A 322	Amount of unissued capital, undertakings to increase capital, categories of persons having preemptive rights, terms and conditions relating to the above
	A 323	Classes of stock not representing capital
	A 323a*	Amount of convertible securities and warrants and conditions thereof
	A 324	Conditions in Charter governing changes in capital and rights if more stringent than law
	A 325	Summary of operations in last three years that have changed the capital stock
	A 328*	Amount of stock of issuer held by itself or subsidiary if not shown separately on balance sheet

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Form 20-F		Sixth Directive
b) Indicate whether registrant has been filing reports with the SEC	A 512	If more than nine months has elapsed since the end of the fiscal year in which the financials have been published, an interim statement covering at least the first six months shall be included
Item 1: Description of Business	A 314*	Indication of company's purpose and reference to Charter
a) Year Organized	A 312*	Date of incorporation and length of life except where indefinite
b) Bankruptcy, if any	A 325	Summary of capital stock changes in last three years
c) Nature of any other material reclassification, merger or acquisition or disposition of assets	A 325	(See above)
d) Any material change in mode of conducting business	A 411*	Description of activities, indicating any new ones
	A 417	Where information in 411-416 has been influenced by exceptional factors, so state
e) Principal products and services	A 411	Description of main categories of products manufactured and sold and/or services performed; also new products
f) Breakdown of total sales and revenue (5 years) by categories of activity and into geographic markets. If profit contribution of any category materially different, identify and discuss; but need not give actual operating profit if not required by foreign law	A 413	Breakdown of net turnover during the past three years by categories of activity and into geographical markets ("homogenous activity which contributes significantly to turnover shall be considered a separate category of activity" — Council minutes)
	B 413	Net turnover for two years (for debt issue)
g) New products	A 411	See above (also 43 below)
h) Research and development expenditures for last two years	A 43	Information concerning policy on research and development over past three years where significant
i) Describe distinctive aspects of registrant's operations and industry	A 417	Where the information in 411-416 is influenced by exceptional factors, so state
j) Material country risks		(See 417 above)
k) Customers, suppliers		
l) Regulation		
m) Proprietary products	A 42*	Summary information regarding the extent to which the company is dependent upon patents, licenses, or other contracts

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Form 20-F	Sixth Directive	
n) Cyclicality	A 44a	Information on any significant interruptions in the company's business in the recent past
o) Energy and raw material supply		
No comparable 20-F requirement	A 45	Average numbers employed by main business activity and changes over last three years, if material
	A 46	Investment policy
	A 461	Description of main investments made in other companies over past three years and current year
No comparable 20-F requirement	A 462	Principal investment made other than in other companies (geographic distribution and method of financing)
No comparable 20-F requirement	A 463	Future investments (like 462) which are committed
Item 2: Management's Discussion and Analysis of Statements of Income	Ch. 7	The company's recent development and prospects
	A 71*	Except as waived by the competent authority, general information and the trend of the company's business since the end of the last fiscal year
No comparable requirement; but projections now permitted by Rule 175	A 72*	Except as waived by the competent authority, information on the company's prospects for at least the current financial year
Item 3: Description of Property	A 415*	Location and size of the company's principal establishments (those accounting for 10% of turnover or production) and summary information about real estate owned
a) Description of plants, mines, etc. and basis of ownership (fee, lease, etc.)	A 416*	For mining, etc., description of deposits, reserve estimates, economic conditions, etc.
	A 417*	(See above)
Item 4: Control of Registrant		
a) Whether registrant is controlled by another corporation or government	A 326	As far as known to company, the natural or legal persons who, directly, or indirectly, severally or jointly, exercise or could exercise control over the company. Particulars of the proportion of capital held by the above persons giving the right to vote
	A 327*	If company is part of a group, a description of group and company's position

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Form 20-F	Sixth Directive
b) If voting securities are in registered form, list owners of 10% or more and give holdings	A 326a Insofar as known to the company, list of shareholders who, directly or indirectly hold a percent which the member states can fix at not more than [20%]
c) Describe arrangements known to registrant which may, at a subsequent date, result in a change of control	A 326 (See above)
Item 5: Directors and Officers	A 61 Names, addresses and functions in the company and principal activities performed by them outside the company where significant of following persons: A 611 members of the administrative, management or supervisory bodies A 612 general partners in the case of a limited partnership with share capital A 613 founders if the company less than five years old
Item 6: Remuneration of Directors and Officers	A 61* Interests of the directors, etc. in the company
a) Aggregate remuneration of officers and directors as a group	A 621 Remuneration paid and benefits in kind to members of administrative, management, and supervisory bodies by group; includes remuneration from other companies in a group (see 56 relative to a dominant company in a group)
b) Pension, retirement plans, etc. for officers and directors. If individual information is published elsewhere, include that	A 622 Total number of company shares held by the above and options granted to them A 63 Schemes for involving staff in the capital of the company
Item 7: Options to Purchase	A 622 (See above)
a) Securities from registrant or subsidiaries	A 322 Subscription options granted, categories of persons having such rights, and terms and arrangements relating thereto A 63 Schemes for involving staff in the capital of the company
Item 8: Pending Legal Proceedings	
a) Describe material pending legal proceedings including the name of the court or other forum, date instituted, parties, alleged factual basis and relief sought; also include legal proceedings known to be contemplated by governmental authorities	A 44* Information on any legal or arbitration proceedings which may have or have had a significant effect on the company's financial position in the recent past

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Form 20-F	Sixth Directive
Item 9: Nature of Trading Market	
a) Describe nature and extent of principal non-U.S. and U.S. trading markets	A 225 Stock exchange or exchanges on which listing is sought
	A 243 Respective dates on which shares will be listed on or dealt in
	A 244 If shares of the same class are already listed on one or more stock exchanges, so indicate
	A 245 If shares of the same class have not yet been admitted to listing, but are dealt in one or more other markets, which are subject to regulation, so indicate and describe
Item 10: Capital Stock to be Registered	A 22 Information concerning the shares to be admitted to listing
a) Outline dividend, liquidation, pre-emptive and conversion rights, redemption and sinking fund provisions, and assessability	A 221 Resolutions, etc. creating said shares; nature of issue and amount thereof
	A 241 Description of shares, number and par or nominal value
	A 221a In a business combination for shares, indication of where documents available to public
	A 222 Concise description of the rights attaching to the shares: voting, dividend,liquidation; time limit after which dividend lapses and party who benefits therefrom
	A 223 Arrangements for transfer of shares and any restrictions on negotiability
	A 224 Date on which entitlement to dividend arises
	A 226 Paying agents
	A 230 Pre-emptive rights of shareholders
	A 234 Procedure for exercise of pre-emption
	A 23 Information concerning the previous issue, public or private, of the shares to be admitted to listing where effected within one year
b) If rights of shareholders may be modified otherwise than by vote of majority	A 222 (See above)
c) State whether or not any restriction on repurchase of shares while dividend or sinking fund in arrears	

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Form 20-F	Sixth Directive
Item 11: Debt Securities to be Registered	[For debt securities Annex B of the Sixth Directive governs]
	B 22 Legal information
Outline	B 221 Resolutions creating debt, type of operation and amount
	B 21 Condition of loan
a) Provisions with respect to interest, conversion, maturity, redemption, amortization, sinking fund or retirement, guarantees	B 211 Amount of loan, nature and denominations
	B 212 Issue and redemption prices and nominal interest rates
	B 213 Procedures for the allocation of other advantages
	B 215 Amortization provisions
	B 2181 Period of loan and any interim due dates
	B 2182 Due dates for interest
	B 222 Nature and scope of guarantees (see also Article 8:1)
	B 224 Subordination provisions
	B 226 Whether registered or bearer certificates
	B 227 Restrictions on transferability
	B 323a Amount of convertible debt securities, etc. and conditions covering conversion, etc.
	B 214 Tax on the income from debt securities withheld at country of origin or country of listing
	B 219 Indication of yield to maturity and method of calcualtion
b) Lien priorities	
c) Maintenance provisions (asset ratios, etc.), dividend restrictions	
d) Provisions relating to issuance of additional securities, modification of the terms of the securities, etc.	B 221 Number of debt securities which have been or will be created if predetermined
e) Particulars relative to the trustee	B 223 Trustee or other representative of debt holders, name and office and conditions of such representation and conditions relating to replacement; location of contract with trustee for public inspection
f) Name and address of paying agent	B 216 Paying agents in the country of admission
g) Currency in which payable and basis for determination	B 217 Currency of the loan; if denominated in units of account, the contractual status thereof; currency option
h) Relevant laws or decrees	B 225 Legislation under which debt securities have been created and courts competent in the event of litigation

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Form 20-F	Sixth Directive
i) Default provisions	B 218 Time limits B 2182 Time limit on the validity of claims to interest and repayment of principal B 225 (See above)
Item 12: Other Securities to be Registered	
If securities other than capital stock or long-term debt are to be issued, outline briefly the rights evidenced thereby	[See Annex C Layout for listing particulars for the admission of certificates representing shares--does not apply if only shares represented are themselves admitted, e.g., shares held by a depository]
Item 13: Exchange Controls and Other Limitations Affecting Security Holders	
Item 14: Taxation	
a) Outline taxes and withholding provisions to which U.S. security holders are subject under the laws and regulations of the foreign country of origin	A 222a*Tax on income from the shares withheld at source in the country of origin and/or the country of listing. Indicate whether the issuer assumes responsibility for the withholding of tax at source
Item 15: Changes in Securities and changes in Security for Registered Securities	
a) Describe material modifications in any class of registered securities	
b) Effect on class of registered securities of issuance or modification of other securities if material	
c) Describe material withdrawal or substitution of assets securing a registered class of securities	
d) Names and addresses of any substitute trustees or paying agents (in last fiscal year)	
Item 16: Defaults Upon Senior Securities	
a) State nature of any material default with respect to any indebtedness exceeding 5% of total unconsolidated assets	
b) State nature of any material arrearage or delinquency with class of registered preferred	

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Form 20-F	Sixth Directive
Item 17: Interest of Management in Certain Transactions	
Describe	
a) Material transactions in last three years or any presently proposed transactions to which registrant is a party in which a director, officer, Item 4(a) security holder, or relative thereof living in the same house is a party	A 623 Information about the nature and extent of interest of administrative management and supervisory bodies in transactions which are unusual in nature or conditions during preceding and current fiscal year as well as executory arrangements made in prior fiscal years
b) The extent to which any director, officer or associate thereof is indebted to registrant and the details	A 624 Total of all outstanding loans by company to the above (623) as well as any guarantees provided by the company for their benefit
Signatures	A 11* Identity of legal or natural persons assuming responsibility for listing particulars
	A 12* Declaration by above persons that document is in accord with facts and no omissions likely to affect its implications
Item 18: Financial Statements and Exhibits	A Ch.5 Information concerning the company's assets and liabilities, financial situation, and profits and losses
Instructions	
1. File same financial statements, schedules and accountant's certificates required for 10-K	A 511* Last three balance sheets and profit and loss accounts set out as a comparative table. Notes on annual accounts for last fiscal year. Must not be more than 18 months old. [B 511 only 2 years plus interim]
	A 56* Where company is dominant entity in a group, details in Ch. 4-7 shall be given for whole group
	B 514 As of recent date: a) total loan capital outstanding guaranteed and not guaranteed b) other indebtedness c) contingent liabilities
Any material variation in accounting principles or practices from U.S. GAAP or Form S-X to be disclosed and to the extent practicable, the effect of each such variation given	A511a* If company prepares consolidated accounts only, it shall include those accounts; if both consolidated and unconsolidated, include both (competent authority may permit omission of one if they do not provide significant additional information)

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Form 20-F	Sixth Directive
2. SEC may permit omission of one or more statements or the substitution of comparable statements. SEC may also permit omission of one or more GAAS or substitution therefor	A514a* Source and application of funds for three years A 511b Per share amounts for three years adjusted for increases or decreases in shares showing details A 511c Amount of dividends per share for three years A 512* If more than nine months has elapsed since the end of last fiscal year, an interim financial statement covering at least the first six months. Any significant change since last fiscal year or interim must be described in a footnote A 513* If unconsolidated or consolidated accounts do not comply with EEC Council Directives and do not give a true and fair view of the company's assets and liabilities, financial position and profits and losses, more detailed or additional information must be given A 551* Consolidation principles applied (including equity accounting) A 52* Details relative to the company's participation in a group (equity accounting type interests) [A 521-531 give details] A 54 Some details for investments not covered by A 52 where company owns at least 10% of capital
Independent accountants' certificate	A 73* Names, addresses and qualifications of the official auditors who audited company's account for the last three years; any qualifications or refusals to report
Instructions As to Exhibits	
A. Registration Statements to Include	A 315* Indication of where documents referred to in the listing application may be inspected
1. Charter and by-laws 2. Copies of acquisition, readjustment or succession described in Item 1 or 8	
3(a) Specimen copies of securities to be registered and of instruments defining rights of long-term debt holders	Article 10 In a business combination the documents describing the transaction must be available at the office of the issuer and its fiscal agent
(b) Certain instruments may be omitted	A 221a
4(a) Copies of every material executory contract not in the ordinary course of business entered into not more than two years before. See Rule 24b-2 for confidential treatment.	

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Form 20-F	Sixth Directive
4(b) Certain contracts of registrants in ordinary course of business must also be filed: (1) where directors, officers or promoters are parties (2) it is of such materiality as to call for reference under Item 1, 3 or 17, or (3) registrant's business is substantially dependent upon it, e.g., requirement's contract	[The Sixth Directive at Sections A 232-A 239 and B 241-B 1247 contains items relating to the particular distribution such as underwriting arrangements which in U.S. would be found in a 1933 Act registration.]

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APPENDIX XIV-B

OUTLINE OF CURRENT DISCLOSURE ISSUES

I. RECENT HARMONIZATION INITIATIVES

A. SEC Form 20-F

1. Almost all non-North American issuers may use Form 20-F to list and register a class of securities on a national securities exchange, and may also file annual reports on Form 20-F. Thus, it is unique in that it is an initial registration and periodic filing form.

2. As proposed in 1977, Form 20-F would basically have required foreign issuers to follow the rules applicable to domestic issuers. These proposals were severely criticized by the commentators.

3. After studying the various disclosure guidelines of the OECD, EEC and the UN, the SEC adopted Form 20-F with substantial revisions in recognition of the special situation of foreign issuers. Securities Exchange Act Rel. No. 16371 (Nov. 29, 1979).

a. Description of Business: Proposal would have required foreign issuers to report the revenues, income and assets for each industry and geographic segment. As adopted, Form 20-F requires quantitative disclosure on a revenue basis only, plus a narrative discussion if revenue and profit contributions of the respective segments differ significantly. In addition, Form 20-F requires the disclosure of sales and revenues by geographic markets.

b. Remuneration of Directors and Officers: Proposal would have required identification of *three* highest paid directors or officers and the disclosure of the aggregate remuneration as well as similar benefits paid to these three persons. As adopted, Form 20-F limits disclosure to aggregate remuneration and similar benefits paid to *all* directors and officers as a group.

c. Interest of Management in Certain Transactions: Proposal would have required a description of material transactions between the issuer and its management. As adopted, Form 20-F requires these disclosures on interested transactions only to the extent such information is already made public pursuant to foreign laws or otherwise.

d. Financial Statements: Financial statements of foreign issuers do not have to comply with GAAP or Regulation S-X; instead, a discussion of any material differences from GAAP or Regulation S-X must be included, and quantification is encouraged to the extent feasible.

B. Sixth Directive of EEC

1. The Sixth Directive contains disclosure requirements for securities when they are first listed on a stock exchange of an EEC member state. (80/390/EEC OJ No. L 100, 17.4.80).

a. A detailed comparison between the Sixth Directive and Form 20-F is attached as Appendix A to this chapter. While the similarities between the specific disclosure items in these two sets of rules are striking, there are some significant differences in general coverage.

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b. The Sixth Directive requires a prospectus to be disseminated to investors; Form 20-F is a form to be filed with the SEC. The Sixth Directive requires a prospectus to be delivered when a new class of securities is listed, and when a new issue of securities of the same class is sold because such a new issue must itself be listed according to the Listing Directive, described below. By contrast, Form 20-F is filed when a new class of securities is listed and annually with regard to such class, but *not* in the event that new securities of such class are issued because such a new issue is subject to the disclosure requirements of the Securities Act of 1933. Thus, a comparison should also be made between the new issue requirements of the Sixth Directive and the disclosure requirements of the Securities Act of 1933. *See, also,* Proposal for a Council Directive coordinating the requirements for the drawing up, scrutiny and distribution of the prospectus to be published when securities are offered for subscription or sale to the public, OJ No. C 355, 31.12.80, p. 39.

2. The Listing Directive of the EEC has two main parts: it sets minimum requirements to be met before securities may be listed on stock exchanges in EEC member states, and prescribes the continuing obligations of the issuers of such listed securities. (79/279/EEC, OJ No. L 66, 16.3.79).

a. The first part is roughly analogous to the criteria proposed by the SEC for qualified securities to trade in the national market system. Securities Exchange Act Rel. No. 15,926 (June 15, 1979). That is, the requirements go mainly to the characteristics of the issuer and its trading market.

b. The second part is roughly analogous to the annual reporting requirements in Form 10-K for domestic issuers (or Form 20-F for foreign issuers). But the information required by the Schedules of the Listing Directive must be made publicly available in a widely distributed newspaper; this is closer to the annual report to shareholders in the United States. On the other hand, the Listing Directive is limited to listed securities, while the 10-K requirements apply to listed securities and OTC securities meeting Section 12(g) standards--500 shareholders and $1 million in assets. In addition, the Listing Directive has a requirement, analogous to Form 8-K requirements, to apprise shareholders of significant developments affecting security prices.

3. The proposed Information Directive would require companies whose securities are admitted to official listing on a stock exchange in an EEC member state to publish a half-yearly report. (OJ No. C 29, 1.2.79). It has been proposed in revised form. (23 OJ No. C 210, 10.19.80). This Directive is roughly analogous to the requirements of Form 10-Q for domestic issuers (and Form 6-K for foreign issuers).

II. TWO SPECIFIC ISSUES OF CURRENT IMPORTANCE

A. 1933 Act Disclosure

1. While the revisions in Form 20-F under the Securities Exchange Act of 1934 are laudable, they need to be matched by similar revisions in the 1933 Act forms. Form 20-F pertains only to reporting standards for *already issued* securities of foreign issuers; therefore, they are of much less utility if the standards for *issuing these securities in the first place* are unduly stringent.

2. The SEC has provided some relief in 1933 Act filings by allowing:

a. foreign issuers to make only aggregate disclosure on management remuneration, Securities Act Rel. No. 6157 (Nov. 29, 1979);

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b. foreign issuers filing Form 20-F to use Form S-16 for rights offering to existing U.S. shareholders, Securities Act Rel. No. 6156 (Nov. 29, 1979);

c. foreign governments and political subdivisions thereof to file an annual shelf registration statement with a core prospectus that can be supplemented quickly by post-effective amendments at the time of the offering, Securities Act Rel. No. 6240 (Sept. 10, 1980).

3. However, there are still significant constraints on 1933 Act filings which are not present in Form 20-F:

a. Description of Business--in 1933 Act filings, foreign issuers still must comply with the full industry and geographic segment disclosure requirements, although these have been significantly reduced in Form 20-F;

b. Interest of Management in Certain Transactions--in 1933 Act filings, foreign issuers still must disclose material transactions between the registrant and its management, although such disclosures are required by Form 20-F only if already being made public, pursuant to foreign laws or otherwise; and

c. Financial Statements--in 1933 Act filings, foreign issuers must go much further than in Form 20-F not only to discuss material differences between GAAP and foreign accounting principles but also to reconcile such differences in a quantitative manner. Reg. 4-01(a); Securities Act Rel. No. 6233 (Sept. 2, 1980).

4. In connection with its integration proposals, Securities Act Rel. No. 6235 (Sept. 2, 1980), the SEC asked several questions about the application of such proposals to offerings by foreign issuers. The integration proposals envisage three filing modes:

a. Form A for S-16 issuers, which would have a high degree of incorporation by reference;

b. Form B for middle-tier companies along the lines of S-7 issuers which could either deliver an annual report along with the prospectus, or include certain information from the report in the prospectus; and

c. Form C for all the remaining companies which is basically a streamlined version of Form S-1. *See* Securities Act Rel. No. 6331 (Aug. 6, 1981), in which these forms have been reproposed as Forms S-1, S-2 and S-3.

5. The SEC questions about the applicability of these integration proposals to foreign issuers included:

a. Whether the criteria for Forms A and B should be used for foreign issuers or whether a different classification system is appropriate;

b. Whether the present distinctions between North American and other foreign issuers should be maintained;

c. Whether the existence of a primary market outside the United States should lead to different disclosure requirements for foreign issuers;

d. Whether foreign laws impede or restrict the information foreign issuers may file with the SEC;

e. Whether the composition of investors in foreign securities are different than investors in domestic securities and, if so, the implications for disclosure requirements; and

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f. Whether the information required by Form S-1 that is not required by Form 20-F is important for investors, analysts, or other interested persons.

B. Proposed EEC Directive on Disclosure to Employees

1. In many European countries, there are legal requirements for consultation by corporate directors with labor unions or appointment of labor representatives to corporate boards.

a. For discussion of Dutch requirement for consultation with labor representatives before entering merger agreements, *see* International Faculty for Corporate and Capital Market Law, Annual Report 1980 at 6.

b. For discussion of German experience with labor representatives on corporate boards, *see* Vagts, "Reforming the Modern Corporation: Perspectives from the German," 80 Harv. L. Rev. 23 (1966).

c. *See also* EEC Directive of February 2, 1975, providing for disclosure and consultation by corporations with labor unions in cases of collective dismissals; and EEC Directive of February 14, 1977, providing for similar procedures in cases of relocation of enterprises.

2. On October 1, 1980, the EEC Commission approved "Proposal for Informing and Consulting the Employees of Undertakings with Complex Structures, in Particular Transnational Undertakings".

a. An unofficial English translation of the proposal follows this outline.

b. Proposal has been submitted to the EEC Council and now must undergo lengthy review process in EEC institutions and by member states.

3. Firms Covered by Directive

a. *Multinational* firms headquartered *outside* an EEC member state, with at least one subsidiary in an EEC member state having at least 100 employees.

b. *Multinational* firms headquartered *within* an EEC member state, with at least one subsidiary in an EEC member state having at least 100 employees.

c. *National* firms headquartered *within* an EEC member state and with at least one subsidiary having at least 100 employees within that same state.

d. Does *not* apply to EEC firms with no subsidiaries in EEC member states (*e.g.*, divisions only), or to American firms doing business in EEC member states through means other than subsidiaries (*e.g.*, agents only).

4. Periodic Disclosures (at least every 6 months)

a. Management of parent company must forward certain information to the management of its subsidiaries which in turn must communicate without delay to employees' representatives in each subsidiary.

b. Such information shall in general be sufficient to give "a clear picture of the activities of the dominant undertaking and its subsidiaries taken as a whole."

c. In specific, the information shall cover the following subjects: structure and manning, economic and financial situation, probable development of business, probable employment trends, rationalization

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

plans, introduction of new working methods, and "all procedures and plans liable to have a substantial effect on employees' interests."

5. Important Decisions

a. These are generally defined as: closure or transfer of an establishment; restrictions, extensions or substantial modifications of activities; major organizational modifications; and the beginning or ending of long-term cooperation with other firms.

b. Not later than 40 days before the adoption of such decision, parent management must forward certain information to subsidiary management, which in turn must forward without delay such information to the employees' representatives and ask for their opinion in not less than 30 days.

c. The required information includes the details of the grounds for the decision, its consequences for the employees concerned, and the measures planned for such employees.

d. If, in the opinion of the employees' representatives, the proposed decision "is likely to have a direct effect on the employees' terms of employment or working conditions", subsidiary management must consult with these representatives on the measures planned for the affected employees.

6. Enforcement and Administration

a. If subsidiary management does not comply with requirements outlined in paragraphs 4 or 5 above, employees' representatives first have recourse to management of the parent. In addition, "appropriate penalties" are to be established by EEC member countries.

b. Employees' representatives must "maintain discretion as regards information of a confidential nature," and may not divulge "secrets regarding the undertaking or its business." EEC member countries "shall impose appropriate penalties in cases of infringement of the secrecy requirement."

c. Proposed directive contemplates possibility of a body representing employees of all subsidiaries of a corporation in EEC member countries--that is, a genuinely transnational union.

d. Proposal contemplates that each EEC member country will "introduce the laws, regulations and administrative provisions necessary to comply with the Directive," thus leaving the details to be worked out by each country.

III. GENERAL APPROACHES

A. Current Approach of Voluntarism

1. Regulation is increased as the degree of voluntary entry by the foreign issuer into the domestic securities markets increases.

2. Maximum regulation if foreign issuer registers securities offering in domestic country and lists on domestic exchange.

3. Minimum regulation if securities of foreign issuer are traded in the OTC market of the domestic country without any participation or support by foreign issuer.

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B. Voluntarism in the U.S.

1. Securities of all foreign issuers are, in the view of the SEC, subject to the antifraud prohibitions in Sections 10(b) and 14(3). SEC Amicus Curiae Brief, *Brascan Ltd. v. Edper Equities Ltd.*, 477 F. Supp. 773 (S.D.N.Y. 1979).

2. Securities of foreign North American securities—primarily Canadian issuers:

a. In general, are treated the same as U.S. issuers.

b. Thus, the exemptions and special reporting forms mentioned below are generally *not* available to foreign North American issuers.

3. Securities of foreign issuers listed on a U.S. exchange.

a. Subject to reporting requirements in Section 13(a) of the 1934 Act, though, can use Forms 20-F and 6-K.

b. Subject to FCPA—Sections 13(b)(2) and 30A of the 1934 Act.

c. Subject to tender offer provisions in Section 14(d) of the 1934 Act.

d. Exempt by Rule 3a12-3 from the short-swing trading provisions in Section 16 and the proxy provisions in Sections 14(a), 14(b), 14(c), and 14(f) of the 1934 Act.

4. Securities of foreign issuers subject to continuous reporting obligations *solely* because of Section 15(d) of the 1934 Act which applies to securities issued pursuant to a registration statement filed with the SEC.

a. Reporting obligations can be fulfilled by filing Forms 20-F and 6-K.

b. Subject to FCPA—Sections 13(b)(2) and 30A.

c. Like domestic 15(d) issuers, foreign 15(d) issuers are not subject to Sections 14(a), 14(b), 14(c), 14(d), 14(f), or 16.

5. Securities of foreign issuers whose securities are traded on the OTC market in U.S., but which have neither been listed on an exchange nor issued in an offering registered with the SEC.

a. In general, Section 12(g) of the 1934 Act imposes obligations, similar to those for listed issuers, if the issuer of the OTC securities has more than 500 shareholders of record and $1 million in assets.

b. However, Rule 12g3-2(a) exempts from all these obligations a foreign issuer if it has fewer than 300 U.S. shareholders of record even if it has more than 500 total shareholders.

c. Rule 12g3-2(b) exempts from all these obligations a foreign issuer, regardless of the number of its U.S. shareholders of record, if it furnishes to the SEC for public inspection copies of the material investor information it makes public in its local jurisdiction or sends to its shareholders either voluntarily or pursuant to foreign law or exchange requirements.

d. Query: what are the obligations of Section 15(d) foreign issuers that also meet the criteria of Section 12(g) in light of Rule 12g3-2(d)?

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C. Limits of Voluntarism

1. No international coordination

a. Each country applies its own laws to the extent that foreign issuer enters the domestic market.

b. Possible incentive for each country to set standards of relatively low level to attract foreign offerings.

2. Role of U.S. standards

a. U.S. standards have been relatively high and have been used as a model by other countries to some degree.

b. The ability of U.S. to retain relatively high standards was premised on very strong desire by foreign issuers to tap the U.S. capital markets.

c. But the dominance of the U.S. as the source of capital has declined as a result of the growth of European and other markets.

d. To the extent that international capital raising and securities trading move outside the U.S. boundaries, it will become more difficult for U.S. regulators to oversee these markets.

D. Minimum Standards

1. Explanation

a. This approach would involve an international agreement on minimum regulatory standards to be applied by all signatory countries, though each country could impose additional standards.

b. EEC Directive on listing sets minimum standards for trading of securities on exchanges in member countries, though each country may impose additional non-discriminatory standards.

c. The International Federation of Exchanges has tried to establish minimum standards for listing on the major exchanges in the world.

2. Evaluation

a. It would reduce the incentive for each country to lower standards so as to attract more foreign capital, and would provide a starting point for creating an international trading market in securities.

b. But there is great pressure to set minimum standards quite low so that exchanges would not have to delist a substantial number of issuers.

c. Moreover, most issuers that might have to be delisted because of minimum standards are relatively small and not interested in foreign trading.

E. Maximum Standards for World Class Securities

1. Explanation

a. This approach would involve an international agreement on maximum regulatory standards which, if met, would automatically entitle the issuer to distribute stock in any country and to list on any exchange in the world. Once maximum standards were set, no regulatory body or exchange could impose additional standards.

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b. The standards would be designed to cover securities of world class issuers. The standards would therefore be fairly high, perhaps at the level of securities trading on the NYSE or AMEX.

2. Evaluation

a. Maximum standards would be an important first step toward an international securities market since they would be aimed at the very large issuers which might have an interest in issuing securities and trading in various countries.

b. But the maximum standards approach would fall far short of an integrated international market system with composite quotation, reporting, and clearing systems. At the same time, an increase in multiple trading locations for the same security would create additional regulatory problems such as in the area of best execution.

c. Maximum standards would not require delisting of small companies since an exchange could set lower standards for securities other than world-class securities.

d. But maximum standards could not be so high that they could be utilized only by U.S. issuers. On this point, the results of an informal survey of selected countries are shown below:

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FOREIGN ISSUERS THAT MEET LISTING REQUIREMENTS
FOR NEW YORK OR AMERICAN STOCK EXCHANGE IN SELECTED COUNTRIES

Country	Companies which meet NYSE or AMEX Listing Requirements
United Kingdom	NYSE - estimated 220 British companies AMEX - estimated 400-450 additional British companies
Sweden	NYSE - 14 Swedish companies appear to meet all criteria AMEX - 15 additional Swedish companies appear to meet all criteria
Belgium	NYSE - 11 Belgian companies appear to meet all criteria other than those relating to number of public shareholders and value of publicly-held shares AMEX - 15 additional Belgian companies appear to meet all criteria other than those relating to number of public shareholders and value of publicly-held shares (All shares issued by Belgian companies are bearer certificates, so information about the number of public shareholders and the aggregate market value of publicly-held shares is not available)
Japan	NYSE - 260 companies listed meet net tangible assets - 80 companies listed also meet pre-tax income - 250 companies listed meet requirements re aggregate market value of publicly-held shares AMEX - 660 companies listed meet net tangible assets - 200 companies listed also meet pre-tax income - over 600 companies meet requirements on aggregate market value of publicly-held shares (The response from Japan did not indicate whether information was being provided only with respect to Japanese companies or for all companies listed on the Stock Exchange, including foreign companies)
Luxembourg	NYSE - 7 listed companies meet net tangible assets - none meet requirements for pre-tax income AMEX - 11 listed companies meet net tangible assets - 8 listed companies meet requirements for pre-tax income (All shares listed are bearer shares, so information about the number of public shareholders and the aggregate value of publicly-held shares is not available)

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APPENDIX XIV-C

PROPOSAL FOR A DIRECTIVE ON PROCEDURES FOR INFORMING AND CONSULTING THE EMPLOYEES OF UNDERTAKINGS WITH COMPLEX STRUCTURES, IN PARTICULAR TRANSNATIONAL UNDERTAKINGS

The Council of the European Communities,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 100 thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the Economic and Social Committee,

Having regard to the opinion of the European Parliament,

Whereas the Council adopted on 21 January 1974 a Resolution concerning a social action programme [1];

Whereas in a common market where national economies are closely interlinked it is essential, if economic activities are to develop in a harmonious fashion, that undertakings should be subject to the same obligations in relation to Community employees affected by their decisions, whether they are employed in the Member State to whose legislation the undertaking is subject or in another Member State;

Whereas the procedures for informing and consulting employees as embodied in legislation or practiced in the Member States are often inconsistent with the complex structure of the entity which takes the decisions affecting them; whereas this may lead to unequal treatment of employees affected by the decisions of one and the same undertaking; whereas this may stem from the fact that the information and consultation procedures do not apply beyond national boundaries;

Whereas this situation has a direct effect on the operation of the common market and consequently needs to be remedied by approximating the relevant laws while maintaining progress as required under Article 117 of the Treaty;

Whereas this Directive forms part of a series of directives and proposals for directives in the field of company and labour law;

SECTION I - SCOPE AND DEFINITIONS

Article 1

This Directive relates to:

- procedures for informing and consulting employees employed in a Member State of the Community by an undertaking whose decision-making centre is located in another Member State or in a non-member country (Section II);
- procedures for informing and consulting employees where an undertaking has several establishments, or one or more subsidiaries, in a single Member State and where its decision-making centre is located in the same Member State (Section III).

[1] No. C 13, 12.2.74, at 1.

https://scholarship.law.upenn.edu/jil/vol3/iss3/1

Article 2

For the purposes of this Directive the following definitions shall apply:

(a) *Employees' representatives*

The employees' representatives referred to in Article 2(c) of Council Directive 77/187/EEC of 14 February 1977 on the approximation of the Laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of businesses [1].

(b) *Management*

The person or persons responsible for the management of an undertaking under the national legislation to which it is subject.

(c) *Decision-making centre*

The place where the management of an undertaking actually performs its functions.

Article 3

1. For the purposes of this Directive an undertaking shall be regarded as dominant in relation to all the undertakings it controls, referred to as subsidiaries.

2. An undertaking shall be regarded as a subsidiary where the dominant undertaking, either directly or indirectly (a) holds the majority of votes relating to the shares it has issued, or (b) has the power to appoint at least half of the members of its administrative,management or supervisory bodies where these members hold the majority of the voting rights.

SECTION II - INFORMATION AND CONSULTATION PROCEDURES IN TRANSNATIONAL UNDERTAKINGS

Article 4

The management of a dominant undertaking whose decision-making centre is located in a Member State of the Community and which has one or more subsidiaries in at least one other Member State shall be required to disclose, via the management of those subsidiaries, information to employees' representatives in all subsidiaries employing at least 100 employees in the Community in accordance with Article 5 and to consult them in accordance with Article 6.

Article 5

1. At least every six months, the management of a dominant undertaking shall forward relevant information to the management of its subsidiaries in the Community giving a clear picture of the activities of the dominant undertaking and its subsidiaries taken as a whole.

2. This information shall relate in particular to:

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[1] OJ No. L 61, 5.3.77, at 26.

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(a) structure and manning
(b) the economic and financial situation
(c) the situation and probable development of the business and of production and sales
(d) the employment situation and probable trends
(e) production and investment programmes
(f) rationalization plans
(g) manufacturing and working methods, in particular the introduction of new working methods
(h) all procedures and plans liable to have a substantial effect on employees' interests.

3. The management of each subsidiary shall be required to communicate such information without delay to employees' representatives in each subsidiary.

4. Where the management of the subsidiaries is unable to communicate the information referred to in paragraphs (1) and (2) to employees' representatives, the management of the dominant undertaking must communicate such information to any employees' representatives who have requested it to do so.

5. The Member States shall provide for appropriate penalties for failure to comply with the obligations laid down in this Article.

Article 6

1. Where the management of a dominant undertaking proposes to take a decision concerning the whole or a major part of the dominant undertaking or of one of its subsidiaries which is liable to have a substantial effect on the interests of its employees, it shall be required to forward precise information to the management of each of its subsidiaries within the Community not later than 40 days before adopting the decision, giving details of:
- the grounds for the proposed decision,
- the legal, economic and social consequences of such decision for the employees concerned,
- the measures planned in respect of these employees.

2. The decisions referred to in paragraph (1) shall be those relating to :
(a) the closure or transfer of an establishment or major parts thereof,
(b) restrictions, extensions or substantial modifications to the activities of the undertaking,
(c) major modifications with regard to organization,
(d) the introduction of long-term cooperation with other undertakings or the cessation of such cooperation.

3. The management of each subsidiary shall be required to communicate this information without delay to its employees' representatives and to ask for their opinion within a period of not less than 30 days.

4. Where, in the opinion of the employees' representatives, the proposed decision is likely to have a difect effect on the employees' terms of employment or working conditions, the management of the subsidiary shall be required to hold consultations with them with a view to reaching agreement on the measures planned in respect of them.

5. Where the management of the subsidiaries does not communicate to the employees' representatives the information required under paragraph (3) or does

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not arrange consultations as required under paragraph (4), such representatives shall be authorized to open consultations, through authorized delegates, with the management of the dominant undertaking with a view to obtaining such information and, where appropriate, to reaching agreement on the measures planned with regard to the employees concerned.

6. The Member States shall provide for appropriate penalties in case of failure to fulfill the obligations laid down in this Article. In particular, they shall grant to the employees' representatives concerned by the decision the right of appeal to tribunals or other competent national authorities for measures to be taken to protect their interests.

Article 7

1. Where in a Member State a body representing employees exists at a level higher than that of the individual subsidiary, the information provided for in Article 5 relating to the employees of all the subsidiaries thus represented shall be given to that body.

2. The consultations provided for in Article 6 shall take place under the same conditions with the representative body referred to in paragraph (1).

3. A body representing all the employees of the dominant undertaking and its subsidiaries within the Community may be created by means of agreements to be concluded between the management of the dominant undertaking and the employees' representatives. If such a body is created, paragraphs 1 and 2 shall be applicable.

Article 8

Where the management of the dominant undertaking whose decision-making centre is located outside the Community and which controls one or more subsidiaries in the Community does not ensure the presence within the Community of at least one person able to fulfill the requirements as regards disclosure of information and consultation laid down by this Directive, the management of the subsidiary that employs the largest number of employees within the Community shall be responsible for fulfilling the obligations imposed on the management of the dominant undertaking by this Directive.

Article 9

1. The management of an undertaking whose decision-making centre is located in a Member State of the Community and which has one or more establishments in at least one other Member State shall disclose, via the management of those establishments, information to the employees' representatives in all of its establishments in the Community employing at least 100 employees in accordance with Article 5 and consult them in accordance with Article 6.

2. The management of an undertaking whose decision-making centre is located in a non-member country and which has at least one establishment in one Member State shall be subject to the obligations referred to in paragraph (1).

3. For the purposes of applying this Article, the terms "dominant undertaking" and "subsidiary" in Articles 4 to 8 shall be replaced by the terms "undertaking" and "establishment" respectively.

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SECTION III - PROCEDURES FOR INFORMING AND CONSULTING THE EMPLOYEES OF UNDERTAKINGS WITH COMPLEX STRUCTURES WHOSE DECISION-MAKING CENTRE IS LOCATED IN THE COUNTRY IN WHICH THE EMPLOYEES WORK

Article 10

The management of a dominant undertaking whose decision-making centre is located in a Member State of the Community and which has one or more subsidiaries in the same Member State shall be required, via the management of its subsidiaries, to disclose information to employees' representatives in all subsidiaries employing at least 100 employees in that State in accordance with Article 11 and to consult them in accordance with Article 12.

Article 11

1. At least every six months, the management of a dominant undertaking shall forward relevant information to the management of its subsidiaries in the Community giving a clear picture of the activities of the dominant undertaking and its subsidiaries taken as a whole.

2. This information shall relate in particular to:
(a) structure and manning
(b) the economic and financial situation
(c) the situation and probable development of the business and of production and sales
(d) the employment situation and probable trends
(e) production and investment programmes
(f) rationalization plans
(g) manufacturing and working methods, in particular the introduction of new working methods
(h) all procedures and plans liable to have a substantial effect on employees' interests.

3. The management of each subsidiary shall be required to communicate such information without delay to employees' representatives in such subsidiary.

4. Where the management of the subsidiaries is unable to communicate the information referred to in paragraphs (1) and (2) above to employees' representatives, the management of the dominant undertaking must communicate such information to any employees' representatives who have requested it to do so.

5. The Member States shall provide for appropriate penalties in case of failure to fulfill the obligation laid down in this Article.

Article 12

1. Where the management of a dominant undertaking proposes to take a decision concerning the whole or a major part of the dominant undertaking or of one of its subsidiaries which is liable to have a substantial effect on the interests of its workers, it shall be required to forward precise information to the management of each of its subsidiaries within the Community not later than 40 days before adopting the decision, giving details of:
- the grounds for the proposed decision
- the legal, economic and social consequences of such decision for the employees concerned
- the measures planned in respect of these employees.

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2. The decisions referred to in paragraph (1) shall be those relating to:
(a) the closure or transfer of an establishment or major part thereof,
(b) restrictions, extensions or substantial modifications to the activities of the undertaking,
(c) major modifications with regard to organization,
(d) the introduction of long-term cooperation with other undertakings or the cessation of such cooperation.

3. The management of each subsidiary shall be required to communicate this information without delay to its employees' representatives and to ask for their opinion within a period of not less than 30 days.

4. Where, in the opinion of the employees' representatives, the proposed decision is likely to have a direct effect on the employees' terms of employment or working conditions, the management of the subsidiary shall be required to hold consultations with them with a view to reaching agreement on the measures planned in respect of them.

5. Where the management of the subsidiaries does not communicate to the employees' representatives the information required under paragraph (3) or does not arrange consultations as required under paragraph (4), such representatives shall be authorized to open consultations, through authorized delegates, with the management of the dominant undertaking with a view to obtaining such information and, where appropriate, to reaching agreement on the measures planned with regard to the employees concerned.

6. The Member States shall provide for appropriate penalties in the case of failure to fulfill the obligations laid down in this Article. In particular, they shall grant to the employees' representatives concerned by the decision the right of appeal to tribunals or other competent national authorities for measures to be taken to protect their interests.

Article 13

1. Where in a Member State a body representing employees exists at a level higher than that of the individual subsidiary, the information provided for in Article 11 relating to the employees of all the subsidiaries thus represented shall be given to that body.

2. The consultations provided for in Article 12 shall take place under the same conditions with the representative body referred to in paragraph (1).

3. A body representing all the employees of the dominant undertaking and its subsidiaries within the Community may be created by means of agreements to be concluded between the management of the dominant undertaking and the employees' representatives, unless provision is made for it by national law. If such a body is created, paragraphs 1 and 2 shall be applicable.

Article 14

1. The management of a dominant undertaking whose decision-making centre is located in a Member State of the Community and which has one or more establishments in the same Member State shall be required to disclose, via the management of the subsidiaries, information to the employees' representatives in all its subsidiaries employing at least 100 employees in accordance with Article 11 and to consult them in accordance with Article 12.

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2. For the purposes of applying this Article, the terms "dominant undertaking" and "subsidiary" in Articles 10 to 13 shall be replaced by the terms "undertaking" and "establishment" respectively.

SECTION IV - SECRECY REQUIREMENTS

Article 15

1. Members and former members of bodies representing employees and delegates authorized by them shall be required to maintain discretion as regards information of a confidential nature. Where they communicate information to third parties they shall take account of the interests of the undertaking and shall not be such as to divulge secrets regarding the undertaking or its business.

2. The Member States shall empower a tribunal or other national body to settle disputes concerning the confidentiality of certain information.

3. The Member States shall impose appropriate penalties in cases of infringement of the secrecy requirement

SECTION V - FINAL PROVISIONS

Article 16

This Directive shall be without prejudice to measures to be taken pursuant to Council Directive 75/129/EEC of 17 February 1975 on the approximation of the laws of the Member States relating to collective redundancies [1] and Directive 77/187/EEC or to the freedom of the Member States to apply or introduce laws, regulations or administrative provisions which are more favorable to employees.

Article 17

1. The Member States shall introduce the laws, regulations and administrative provisions necessary to comply with this Directive not later than . . . . . .* They shall forthwith inform the Commission thereof.

2. The Member States shall communicate to the Commission the texts of laws, regulations and administrative provisions which they adopt in the area covered by this Directive.

Article 18

Within two years from the date fixed in Article 17, the Member States shall transmit to the Commission all information necessary to enable it to draw up a report to be submitted to the Council relating to the application of this Directive.

Article 19

This Directive is addressed to the Member States.

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[1] OJ No. L 48, 22.2.75, at 29.

*Date to be specified at the time of adoption by the Council.

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Journal of Comparative Corporate Law and Securities Regulation 3 (1981) 423
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INDEX

Bruyneel, André, Restrictions on foreign investment: Developments in European law 339
Buckley, Peter J., The entry strategy of recent European direct investors in the USA 169
Carswell, Robert, Influence of international banking on bank regulation in the United States 263
Carvalhosa, Modesto, The Brazilian experience with respect to tender offers 103
Coles, Michael H., Foreign companies raising capital in the United States 300
Cooke, W. Peter, Supervising multinational banking organizations: Evolving techniques for cooperation among supervisory authorities 244
Giddy, Ian H., *see* John E. Hoffman, Jr. 271
Greene, Edward F., Integration of the Securities Act and the Exchange Act: A case study of regulation in the Division of Corporation Finance of the United States Securities and Exchange Commission 75
Hawes, Douglas W., A development in insider trading law in the United States: A case note on *Chiarella v. United States* 193
Heleniak, David W., Restrictions on foreign investment: Developments in United States law 330
Herbert, LeRoy J., Developments in harmonization of accounting standards 373
Hirsch, Alain, Supervising multinational banking organizations: Responsibilities of the home country 238
Hoffman, John E. Jr. and Ian H. Giddy, Lessons from the Iranian experience: National currencies as international money 271
Kanazaki, Katsuro, Immobilization of stock certificates: The position of the beneficial shareholder 115
Lehr, Dennis J. and Cameron F. MacRae III, Foreign banks in the United States: Acquisitions, branching, and other techniques 202
Lorne, Simon M., Attorney–client relationships after *Carter and Johnson* 151
MacRae, Cameron F. III, *see* Dennis J. Lehr 202
Mundheim, Robert H., Introduction 199
Nichols, Bruce W., Lessons from the Iranian experience: Impact on loan syndications and other international transactions 287
Peterson, Neal L., Supervising multinational banking organizations: Responsibilities of the host country 225
Pierce, Morton A., The regulation of the issuance and trading of securities in the United States and the European Economic Community: A comparison 129
Pozen, Robert C., International securities markets: Comparative disclosure requirements 392
Regulation of multinational banking institutions: A symposium 49
Simmonds, Ralph L., Proposals for a securities market law for Canada: A review 31
Tatsuta, Misao, Restrictions on foreign investment: Developments in Japanese law 357
von Clemm, Michael, United States companies raising capital abroad 320
Wymeersch, Eddy, From harmonization to integration in the European securities markets 1

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