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## ARTICLES

### **Recent Initiatives in International Financial Regulation and Goals of Competitiveness, Effectiveness, Consistency and Cooperation**

*Joel P. Trachtman\**

This article will examine limited features of the U.S. international regulatory regimes associated with banking and securities in order to compare recent approaches of these regimes to financial activity by foreigners in the U.S. and at home, and by U.S. persons or their subsidiaries abroad. The features examined have been selected based on their centrality to the bank and securities regulation regimes, their particular international concerns and the circumstance of recent administrative and legislative emphasis. Similar methods of analysis could be applied to other features.

The purpose of this examination is first, to review the basis for and method of applying U.S. regulation in these functional areas to offshore activities of U.S. persons and to both U.S. and offshore activities of foreign persons, and to understand the differences in approach taken by the

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Board of Governors of the Federal Reserve System (the Board) and the Securities and Exchange Commission (the Commission) in interpreting the reach of prescriptive jurisdiction under the Bank Holding Company Act of 1956 (the BHC Act),<sup>1</sup> the Securities Act of 1933 (the Securities Act)<sup>2</sup> and the Securities Exchange Act of 1934 (the Exchange Act).<sup>3</sup> The second purpose of this examination is to understand how these approaches compare and relate to certain international or regional initiatives, particularly those of the Basle Committee on Banking Supervision (the Basle Committee) and the European Economic Community (the European Community).

This article will examine initiatives relating to three basic and related types of financial regulation: first, regulation of financial institution powers and prudence; second, regulation of financial institution capital; and third, regulation of financial transactions. The principal U.S. regulations that this article will discuss are:

1. Regulation K<sup>4</sup> (including recent revisions thereof) under the BHC Act and sections 25<sup>5</sup> and 25(a)<sup>6</sup> of the Federal Reserve Act, concerned with the types and extent of activities not normally permitted to U.S. banking organizations that subsidiaries of U.S. banking organizations and that foreign banking organizations operating in the U.S. may undertake abroad;
2. Rule 15a-6<sup>7</sup> under the Exchange Act, concerned with the circumstances under which a foreign securities broker-dealer engaging in activities in the U.S. will not be required to register as a U.S. broker-dealer under Section 15(a)<sup>8</sup> of the Exchange Act; and
3. Regulation S<sup>9</sup> under the Securities Act (as well as the related TEFRA D Rules<sup>10</sup> under the Internal Revenue Code), concerned with the circumstances under which a public offering of securities effected outside the U.S. is not required to be registered under Section 5<sup>11</sup> of the Securities Act.

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<sup>1</sup> 12 U.S.C. § 1841 *et seq.* (1988).

<sup>2</sup> 15 U.S.C. § 77a *et seq.* (1988).

<sup>3</sup> 15 U.S.C. § 78a *et seq.* (1988).

<sup>4</sup> 12 C.F.R. § 211 (1991) [hereinafter *Regulation K*]. The Board of Governors of the Federal Reserve System proposed certain changes to Regulation K on August 1, 1990. 12 C.F.R. § 211, Docket No. R-0703, 55 F.R. 32423, Aug. 9, 1990, CCH FED. BANKING L. REP. [Current] ¶ 88,208 (1990) [hereinafter *Regulation K Proposed Revisions*]. With limited modifications, these revisions were adopted on April 19, 1991. 12 C.F.R. § 211, Docket No. R-0703, 56 F.R. 19549, Apr. 29, 1991, CCH FED. BANKING L. REP. [Current] ¶ 88,444 (release) and CCH FED. BANKING L. REP. ¶ 31,411 *et seq.* (1991) (revised regulation) [hereinafter *Regulation K Revisions*].

<sup>5</sup> 12 U.S.C. § 601 *et seq.* (1988).

<sup>6</sup> 12 U.S.C. § 615 *et seq.* (1988).

<sup>7</sup> 17 C.F.R. § 240.15a-6 (1990). See text accompanying notes 97-122, *infra*.

<sup>8</sup> 15 U.S.C. § 78o(a) (1988).

<sup>9</sup> *Regulation S—Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933*, 17 C.F.R. 230.901-904 (1991) [hereinafter *Regulation S*].

<sup>10</sup> Treas. Reg. § 1.163-5(c)(2)(i)(D) (1991).

<sup>11</sup> 15 U.S.C. § 77(e) (1988).

These regimes established by the Board and the Commission go to the question of the extent of U.S. regulation of offshore financial activities. This article will compare these approaches with related bilateral U.S. initiatives, with regional initiatives of the European Community and with the Basle Committee's multilateral initiative in the area of capital adequacy.

The question posed by this article is, why are there differences in the reach and grasp of these aspects of bank and securities regulation? Further, are these differences sensible, based on the varying purposes of these laws? Are these differences justified by the legislation that underlies the regulation—in other words, has the U.S. made these decisions at its highest policy levels, and should it? Are these differences defensible from the standpoint of efficiency in international finance, and is the inconsistency that in fact exists acceptable to other countries? If not, what alternative approaches are available?

## I. APPROACHES TO INTERNATIONAL FINANCIAL REGULATION

Different countries have different approaches to finance. Despite the revolution in Eastern Europe, many countries still allocate finance using some degree of central planning. Many countries still use financial regulation or guidance domestically to implement industrial or social policy by directing finance toward selected uses in ways that the private market would not. Even countries that emphasize the market as allocator of finance have varying approaches to financial regulation, based on varying regulatory experience, legal culture, economic history and regulatory goals.

International financial regulation is one of the primary areas of attention in connection with proposals to liberalize trade in services. Trade in financial services is being addressed in the Uruguay Round under the General Agreement on Tariffs and Trade (GATT).<sup>12</sup> International finance, however, is not merely a service, but is also a critical factor of production. Few doubt that aggregate worldwide welfare would be enhanced by permitting finance to flow freely to the uses selected by an international free market process. All recognize that uncoordinated national regulatory systems are barriers to this flow.

In considering reform of regulation, it is necessary to consider the costs and benefits of present structures, as well as the costs and benefits of

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<sup>12</sup> See, e.g., *Uruguay Round Service Negotiators Move to Small Groups in Hope of September Texts*, 57 BANKING REP. (BNA) 198 (July 29, 1991), indicating that talks on financial services trade is "quite far advanced," based on two similar proposals to enhance requirements for national treatment.

proposed reforms. This process is complicated enough in the domestic context, requiring careful scientific review of the social costs of, and social benefits from, regulation. However, in order to enhance worldwide aggregate welfare,<sup>13</sup> it is necessary to consider regulation on the basis of worldwide costs and worldwide benefits. This article seeks to begin to consider how financial regulation initiatives may be evaluated in this context.

The analytical factors that might be evaluated with respect to substantive domestic regulation include the social benefits expected to be derived from the regulation and the social costs expected to be incurred in order to implement the regulation. This calculus requires an added dimension in order to evaluate international regulation. This added dimension includes the related problems of (a) regulatory effectiveness in the context of transnational finance, (b) competitiveness of domestic financial and non-financial enterprise in the global economy, (c) consistency of approach with respect to the outside world, and (d) bases for and methods of cooperation in international financial regulation. These issues have an effect on the determination of regulatory structure and scope.

#### A. Regulatory Effectiveness

There are two categories of regulatory concerns that merit special consideration in the international context. First, international regulation is concerned with regulatory effectiveness: to what extent does the discontinuity between transnational finance and national regulation diminish the effectiveness of regulation in accomplishing its purposes, and how can effectiveness be maintained? Regulatory effectiveness will be challenged by transnational finance in different ways, depending on the type of regulation involved. The discontinuity between transnational finance and national regulation challenges regulators because it requires them to apply regulation to persons or transactions that are not exclusively located in their jurisdiction. This problem is often referred to as extraterritoriality: under what circumstances should national regulation govern such persons or transactions? Extraterritoriality is ameliorated by either agreeing on what the substantive domestic rules should be, so that it matters little which country's rules are applied, or agreeing on a method for determining which country's substantive rules govern particular persons

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<sup>13</sup> It is not clear that this is any country's goal; in fact, the existence of protectionism belies this as a possible goal. However, the success and demonstration effects of the European Community's ability to subordinate short-term national welfare to long-term aggregate welfare makes this more of a practical reality.

or transactions. Varying approaches may be appropriate for varying types of regulation.<sup>14</sup>

The general U.S. approach to extraterritoriality of regulatory autarky and autarky has lost some of its force in recent years<sup>15</sup> as a result of a recognition that regulatory effectiveness is compromised by failure to cooperate with foreign regulators, especially in the enforcement area.

The increasing organization of enterprise in corporations, and particularly multinational corporate groups, allows greater flexibility to business to engage in regulatory arbitrage, seeking to oust the jurisdiction of national regulators that impose relatively high costs, in order to enjoy the reduced cost of more efficient or more lax regulation in other jurisdictions. While this process may have positive long-term effects as a discipline on national regulation, as set forth below, in the short term, it may diminish the effectiveness of regulation, including but not limited to enforcement. Effectiveness can be restored through enhanced cooperation.

This observation generates certain consequences under the principle of subsidiarity. This principle would call for a comparison of different social needs and regulatory techniques in the particular regulatory context, based on differences of economic development, legal and political culture and economic institutions, among others, in order to identify the most efficient levels at which to provide regulation. In the context of finance of large enterprise, the most efficient level of regulation may be global, insofar as a universal culture of large-scale enterprise has had a homogenizing effect on regulatory goals of economic efficiency, as well as on possible regulatory techniques. There is already a level of business integration in this area that involves global financial activity and arbitrage, as well as global regulatory arbitrage in finance. Thus, in order for at least some aspects of large-scale financial regulation to be effective, it must be coordinated, and perhaps also formulated, on a global basis.

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<sup>14</sup> Professor Scott and Ms. Key have recently suggested a matrix for analysis of different types of bank regulation, with a view to clarifying the rules that should govern international trade in banking services. They relate the decision among home country regulation, host country regulation and harmonization to the means by which services are provided and to the regulatory or other policy goals sought to be achieved. S. KEY & H. SCOTT, *INTERNATIONAL TRADE IN BANKING SERVICES: A CONCEPTUAL FRAMEWORK* (1991).

<sup>15</sup> It probably reached its zenith in 1984 in connection with the Commission's proposed and ultimately abandoned doctrine of "waiver by conduct." Under this doctrine, persons trading in U.S. markets would be deemed to implicitly waive foreign bank secrecy and other protections afforded by foreign law. Exchange Act Release No. 21,186, 31 SEC Docket (CCH) 14 (July 30, 1984). See Fedders, *Policing Internationalized U.S. Capital Markets: Methods to Obtain Evidence Abroad*, 18 INT'L LAW. 89 (1984).

## B. Competitiveness

Second, international regulation is concerned with competitiveness; this concern is increasingly explicit. Competitiveness must be considered from several perspectives. One perspective considers the regulatory costs incurred by domestic business in comparison to those incurred by foreign competitors: is the domestic regulatory system a negative "factor endowment"? Another perspective considers the ability of domestic business to compete in foreign markets: do domestic persons incur additional costs in foreign host countries in order to comply with home country regulation? Still a third perspective considers the ability of foreign competitors to compete in local markets: are foreign competitors, who may benefit from low home country regulatory costs, or even regulatory subsidies, or who may otherwise be strong competitors, permitted to compete in domestic markets? These issues are addressed explicitly in the formulation of tax policy, where the burden on competitiveness is more apparent and direct.<sup>16</sup>

The policy direction indicated by the competitiveness concern is often unrelated to or opposite to that indicated by the regulatory effectiveness concern. Thus, in formulating policy, these concerns may be required to be compromised between themselves, as well as with other concerns. They will be least inconsistent if two conditions are fulfilled: first, if the competitiveness concern is limited to the first perspective mentioned above—limiting regulatory costs incurred by business—and second, if the regulation concerned is market-facilitating rather than market-inhibiting. That is, the competitive drive to limit regulatory costs will be more consistent with the goal of regulatory effectiveness if regulatory effectiveness is defined in terms of ability to enhance economic efficiency. This is so because if regulatory effectiveness is defined this way, costs would not be permitted to exceed efficiency benefits. In addition,

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<sup>16</sup> See, e.g., Plambeck, *Capital Neutrality and Coordinated Supervision: Lessons for International Securities Regulation from the Law of International Taxation and Banking*, 9 MICH. Y.B. INT'L LEGAL STUD. 191 (1988). International tax analysis considers three aspects of neutrality in connection with its attempt to provide economically neutral taxation. First, capital export neutrality calls for equal taxation on domestic and foreign investment by domestic persons. Second, capital import neutrality from the standpoint of a foreign host country calls for an equal tax burden on both foreign and local investors in connection with local investments. Third, national neutrality calls for equal tax receipts to the home country regardless of where its nationals' investments are made. These principles are mutually inconsistent, insofar as they assume the propriety of tax jurisdiction on the basis of both residence and source. For an economic analysis of the effects of competition, and of coordination, among tax jurisdictions, see P. Musgrave & R. Musgrave, *Fiscal Coordination and Competition in an International Setting*, in INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS: PROCEEDINGS OF THE VIII<sup>TH</sup> MUNICH SYMPOSIUM ON INTERNATIONAL TAXATION (McLure, Sinn, Musgrave, et al. eds. 1990).

positing economic efficiency as a harmonized goal would lead to convergence of regulation, diminishing competitive inequalities.

Market-facilitating regulation is regulation that facilitates the operation of the financial market to allocate capital efficiently. Disclosure regulation in connection with public offerings of securities is an example.<sup>17</sup> An example of market-inhibiting regulation might be regulation that prevents banks from branching across state borders in the United States when it would otherwise be economically efficient for them to do so. This categorization is not intended to indicate that market-inhibiting regulation is necessarily to be avoided: such regulation may serve an important social policy for which a society is willing to pay in terms of reduced allocative efficiency. Rather, it is merely intended to indicate that where regulatory costs are imposed merely to maintain the efficiency of the market, and not to achieve other social goals, the costs will be minimized in a way that promotes competitiveness.

The globalization of finance is a nemesis of inefficient financial regulation. International trade disciplines domestic industry by subjecting it to competition from abroad. On a higher plane, international trade disciplines domestic regulatory regimes. Inefficient regulation imposes costs on domestic industry that are not commensurate with the social benefits obtained. Even efficient, market-facilitating regulation can hinder the competitiveness of domestic industry where lax foreign regulation imposes lower costs on foreign competitors. As more efficient financial regulation is developed in one national jurisdiction that can meet the needs of economic efficiency and stability more effectively or at a lower social cost than other methods, the retention of the other methods imposes an unjustified cost on providers and users of finance. These costs render less competitive the financial institutions, and the industrial firms that must buy financing from these financial institutions, in the jurisdiction with the less efficient regulation.

On February 5, 1991, pursuant to section 1001 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA),<sup>18</sup> Secretary of the Treasury Nicholas Brady provided to Congress

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<sup>17</sup> There is a counter-argument to the effect that the market can impose its own disclosure disciplines. For a cogent analysis of these arguments, see Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984). For a discussion of the possible differences between bank regulation and securities regulation in this regard, see Trachtman, *Perestroika in Bank Regulation: Advantages of Securities Regulation for a Market Economy*, in BANK REGULATION AND SUPERVISION IN THE 1990'S (J. Norton ed. 1991).

<sup>18</sup> § 1001 of the FIRREA, 12 U.S.C. § 1811 (1989) [hereinafter FIRREA]. See, e.g., Gail, *Highlights of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA): What Foreign Banks Should Know*, 24 INT'L LAW. 225 (1990).



a report entitled "Modernizing the Financial System: Recommendations for Safer, More Competitive Banks."<sup>19</sup> On March 20, 1991, a bill was introduced in Congress to implement the recommendations made in this report.<sup>20</sup> In this report and proposed legislation, the U.S. Treasury proposed a wide-ranging reform of the U.S. system of bank regulation, with principal goals to break down functional borders between banking and the securities and insurance businesses, and between banking and commerce, as well as to break down barriers to interstate banking. This initiative is motivated by the challenge of global economic competition. The Treasury stated that "[a] sound, internationally competitive banking system is critical to the Nation's economic vitality and the financial well-being of our citizens."<sup>21</sup>

The U.S. bank regulation and securities regulation regimes have come under increasing competitive pressure to reduce regulatory costs (including opportunity costs due to foregone business) to the minimum necessary, in order to allow U.S. regulatory clients to compete on the most favorable basis possible, consistent with regulatory goals. Adding to this pressure are inconsistencies caused by the introduction of first, less onerous foreign regulation of U.S. regulatory subjects operating abroad and second, foreign financial organizations operating in the U.S. that do not meet the requirements of U.S. regulatory law, but that cannot reasonably be excluded. They cannot reasonably be excluded from the U.S. market for two reasons: first, because the system of regulation under which they operate has proven adequate to address the fundamental regulatory concerns that underlie U.S. regulation, and second, because their exclusion would prompt retaliation under the justification of reciprocity.

### C. Cooperation

Thus, from the standpoint of formulating international regulation, the approach taken to competitiveness matters, as does the approach taken to regulatory effectiveness. Both these factors will have an effect on a particular country's willingness to cooperate with other countries, either explicitly or implicitly.

Implicit cooperation may take the form of unilateral action that de-

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<sup>19</sup> Department of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (1991) [hereinafter *Treasury Report*]. The Treasury Report, or at least a study of the federal deposit insurance system, was mandated by § 1001 of the FIRREA, 12 U.S.C. § 1811 (1989).

<sup>20</sup> S. 713, 102d Cong., 1st Sess. (1991) [hereinafter *Treasury Bill*]. This bill has been the subject of intense debate, and at the date of this article, had not been passed in any form.

<sup>21</sup> Treasury Report, *supra* note 19, at ix.

fers to other countries by limiting the scope of regulatory jurisdiction or providing *de jure* and *de facto* national treatment to foreign nationals, with expectations and hopes, or even unilateral requirements, of reciprocity by the foreign government. The reciprocity may amount to a tacit, consciously parallel agreement with foreign countries. Another form of implicit cooperation unilaterally provides benefits to foreign countries that provide reciprocal benefits: unilateral reciprocity.

Explicit cooperation involves bilateral, regional or multilateral agreements, establishing institutional structures to constrain future action. The first level of explicit cooperation would involve reciprocal agreements to provide national treatment. This would involve no reduction of national regulatory effectiveness, and would compromise only one type of competitiveness: the ability explicitly to exclude foreign competitors. National treatment is a complex concept with significant difficulties, but can be treated here as impartial application of host country rules to foreign entities.<sup>22</sup> A reciprocal national treatment standard, assuming it could be judged and enforced impartially, would reduce intentional barriers to trade in financial services. It would have little effect on *de facto* or unintentional barriers arising from differences in national regulation. It would also have little effect on regulatory differences that are not significant as barriers, but that merely reduce efficiency and raise the costs of transnational flow of finance.

A second level of explicit cooperation would involve agreement on reduction of unintentional barriers. This might involve agreement on compromise of regulatory effectiveness in order to provide *de facto* national treatment, or even better-than-national treatment, to foreign competitors.

A third level of explicit cooperation would seek to reduce regulatory differences that do not amount to significant *de facto* barriers, but that by virtue of their mere difference, raise the costs of transnational flow of finance. This type of cooperation would compromise regulatory effectiveness to the extent that it requires general changes in national regulation that would reduce the ability to effectively address regulatory goals that had previously been addressed. It would compromise competitive concerns to the extent that such concerns are protectionist rather than liberal. It would require joint legislation, which would necessitate a high level of congruence of policy and approach, and which would benefit from an institutional and constitutional infrastructure that would facili-

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<sup>22</sup> For a detailed discussion of the concept of national treatment, see Key, *Is National Treatment Still Viable? US Policy in Theory and Practice*, 5 J.INT'L BANKING L. 365 (1990).

tate agreement, as well as neutral enforcement without the possibility of retaliation for defection or alleged defection.

#### D. Consistency and Mode of International Discourse

In order to consider how the concerns for regulatory effectiveness and competitiveness are evaluated and compromised in international co-operation, it is necessary to consider the actors involved and the context and fora in which they work.

In the U.S. context, much authority has been delegated to or assumed by functional administrative agencies to determine how to apply U.S. regulation to persons or transactions that do not relate exclusively to the United States. This authority has been exercised in establishing unilateral frameworks of reciprocity or deference, as well as, in the case of capital requirements for banks, in establishing agreed substantive rules. Because of the failure to address these issues at the highest legislative policy level, there is a good deal of incoherence of policy among functional agencies, within functional agencies and between the functional agencies and another group of decision-makers: the courts. This atomization of international regulatory policy authority has adverse consequences for the ability to cooperate effectively.

In each of the areas of regulation discussed in this article, prescriptive jurisdiction is exercised over foreign persons or transactions for different reasons and under different circumstances. Thus there is inconsistency in the extraterritorial scope of varying types of U.S. financial regulation. There is also inconsistency within types of regulation. These inconsistencies arise from variation in the basis for application of U.S. law: nationality, territorial effects and territorial conduct.

For example, in banking regulation, nationality is used as a basis to regulate the activities of U.S. banks abroad, while territoriality is used to regulate the activities of foreign banks in the United States. The nationality basis is congruent with the principal thrust of U.S. banking regulation, which regulates institutions in order to ensure their safety and soundness, but it is extended by the territorial conduct principle where foreign banks do business in the United States, in order to avoid possible gaps in regulation, as well as competitive discrimination against U.S. firms. Similarly, a relatively small amount of U.S. conduct could result in a foreign broker-dealer being subjected to the full panoply of U.S. broker-dealer regulation with respect to its foreign operations, in order to protect U.S. customers from foreign broker-dealers that are not subject to U.S. regulation.

Of course, inconsistency is not necessarily inappropriate. However,

it is not necessarily appropriate. When each regulator forms its approach to these problems, it often pays little heed to the approach taken by the other regulators, to the approach used by foreign regulators, or to the need to cooperate with foreign regulators. It should consider these issues, because the United States is a polity of limited powers, the limits in scope of which are not specifically defined.<sup>23</sup> This lack of definition in the Constitution, in U.S. statutes and in international law should not be regarded as an invitation to excess, but rather as a source of responsibility, where unilateral action is necessary, to act on a coherent basis, with due regard for the aggregate of U.S. assertions of prescriptive power and the limits of that power, as well as for the actions by foreign counterparts in similar circumstances.

U.S. regulators should consider the approach taken by other U.S. regulators in order to present to the outside world a coherent vision of the scope of U.S. powers, unfragmented by varying levels of regulatory zeal lacking the moderation that would be instilled by a larger perspective. They should consider the approach taken by foreign regulators because the problem of overlapping and inconsistent regulation among countries can only be resolved by explicit or implicit agreement with other regulators regarding the scope of permissible application of law: agreement on conflict of laws rules. In the European Community's single market initiative, this agreement on which country's law governs is predicated upon a minimal agreement on the content of law. Thus, consistency of internal approach requires a high degree of formal and informal cooperation among regulators within the United States, while consistency of approach among countries is a prerequisite for competitive fairness and to avoid the application of regulation being used to promote domestic industry in an escalating regulatory trade war that would be costly to all.

#### E. Problems of Authorization

Congress has often declined to squarely address the issue of regulatory scope.<sup>24</sup> For example, in connection with antitrust laws,<sup>25</sup> securities

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<sup>23</sup> Neither the Constitution nor international law provides firm guidance as to the scope of a state's power, although it might be argued that these sources should, if they do nothing else, define the scope of the prescriptive power of our country.

<sup>24</sup> See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6(2), comment c (1971). See also Brilmayer, *The Extraterritorial Application of American Law: A Methodological and Constitutional Appraisal*, 50 LAW & CONTEMP. PROBS. 11, 15 (Summer 1987). The Supreme Court, in *Boureslan v. Arabian American Oil Company*, 111 S. Ct. 1227 (1991), has recently held that certain statutory U.S. civil rights (under Title VII of the 1964 Civil Rights Act) are inapplicable to the activities of U.S. businesses operating abroad, as Congress did not evince sufficient intent that they be so applica-

laws,<sup>26</sup> export control laws,<sup>27</sup> certain aspects of the tax laws,<sup>28</sup> and certain aspects of intellectual property laws,<sup>29</sup> U.S. statutes are unclear as to the scope of jurisdiction intended to be exercised, at least in the sense that they claim prescriptive jurisdiction over matters that exceed the grasp of the United States. Congress appears to assume that it is not limited by international law in its assertion of jurisdiction.

At the time that many of these laws were first enacted, the main concern of Congress regarding foreign activity was evasion of U.S. rules by people who deserved to have these rules applied to them, so the scope of application was drafted expansively in order to avoid providing a roadmap for evasion. However, there are other reasons, most of which are beyond the scope of this article.

First, the U.S. has not moderated the scope of its jurisdiction because it has not been required to do so. One reason why the U.S. has not been required to moderate the scope of its jurisdiction is its heretofore preeminent economic and political power in the world, making other countries unwilling to confront the U.S. over these issues. As has been discussed in other contexts, the balance of power is continually shifting, and this reason for failure to moderate is less applicable today.

Second, the U.S. has not moderated the scope of its jurisdiction because in the past it has been easier to see extraterritorial assertions of jurisdiction as something less than a policy conflict: the U.S. was prohibiting activities that foreign governments did not condone or encourage, but had not gotten around to prohibiting. The U.S. was filling a regulatory gap, acting as business police to the world. This is no longer accept-

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ble. This has been viewed by some commentators as a challenge to Congress to clarify the extraterritorial reach of these provisions.

<sup>25</sup> The literature regarding extraterritoriality in antitrust is voluminous. A relatively recent and thoughtful opinion, citing much of the literature, is *Laker Airways v. Sabena, Belgian World Airlines*, 731 F.2d 909 (D.C. Cir. 1984). Judge Wilkey criticized the reasonableness test, described in RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 403 and 415 (1987). In addition, the Department of Justice has promulgated Antitrust Enforcement Guidelines for International Operations, giving an executive perspective on proper means to determine the scope of prescriptive jurisdiction under the antitrust laws. U.S. Dep't of Justice, *Antitrust Enforcement Guidelines for International Operations*, reprinted in 55 ANTITRUST & TRADE REG. REP. (BNA) 1391 (Nov. 17, 1988). See also Foreign Trade Antitrust Improvements Act of 1982, 15 U.S.C. § 6a (1988).

<sup>26</sup> See, e.g., Sachs, *The International Reach of Rule 10b-5: The Myth of Congressional Silence*, 28 COLUM. J. TRANSNAT'L L. 677 (1990).

<sup>27</sup> See, e.g., Abbott, *Defining the Extraterritorial Reach of American Export Controls: Congress as Catalyst*, 17 CORNELL INT'L L.J. 79 (1984).

<sup>28</sup> See discussion of the TEFRA-D rules at text accompanying notes 174-178, *infra*.

<sup>29</sup> See, e.g., *American Rice, Inc. v. The Arkansas Rice Growers Cooperative Assn.*, 701 F.2d 408 (5th Cir. 1983) (extraterritorial reach of U.S. trademark law); *Wells Fargo & Co. v. Wells Fargo Express Co.*, 556 F.2d 406 (9th Cir. 1977) (same).

able for two reasons. The absence of a prohibition in foreign law is increasingly viewed as an affirmative policy decision to permit certain activity, especially in free market economies. And the U.S. is not viewed as having state-of-the-art, neutral business regulation. Others have evaluated U.S. regulation and devised other structures that they find more appropriate.

The above serve as explanations for congressional silence on the issue of extraterritorial scope. The regulators have largely filled the gap left by Congress, and have done so from the perspective of fulfilling their specific regulatory function in accordance with their legislative and political mandates. However, this perspective is incomplete.

## II. FINANCIAL INSTITUTION POWERS AND PRUDENTIAL REGULATION: REGULATION K AND THE SECOND BANKING DIRECTIVE

This section will consider certain critical features of U.S. bank regulation relating to institutional powers that have raised concerns regarding competitiveness and interaction with foreign standards. It will then describe how Regulation K ameliorates these concerns, both for U.S. banking organizations and for foreign banking organizations operating within the United States, and how the recently adopted revisions to Regulation K were intended to further ameliorate these concerns. It will next consider how the approach of Regulation K differs from, and interacts with, the European Community's Second Banking Directive.<sup>30</sup> Finally, it will examine institutional regulation of securities firms under the European Community's proposed Investment Services Directive<sup>31</sup> (which is modelled on the Second Banking Directive) and the Commission's recently promulgated Rule 15a-6.

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<sup>30</sup> *Second Council Directive of December 15, 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC*, 32 O.J. EUR. COMM. (No. L 386) 1 (1989) (Council Directive 89/646/EEC) [hereinafter *Second Banking Directive*]. There are two companion directives to the Second Banking Directive: *Council Directive of 18 December 1989 on a Solvency Ratio for Credit Institutions*, 32 O.J. EUR. COMM. (No. L 386) 14 (1989) (Council Directive 89/647/EEC) [hereinafter *Solvency Ratio Directive*]; *Council Directive of 17 April 1989 on the Own Funds of Credit Institutions*, 32 O.J. EUR. COMM. (No. L 124) 16 (1989) (Council Directive 89/299/EEC) [hereinafter *Own Funds Directive*]. For a discussion of the purposes and mechanics of the Second Banking Directive, see, e.g., Gruson & Feuring, *The New Banking Law of the European Community*, 25 INT'L LAW. 1 (1991); Zavvos, *Banking Integration and 1992: Legal Issues and Policy Implications*, 31 HARV. INT'L L.J. 463 (1990).

<sup>31</sup> *Amended Proposal for a Council Directive on Investment Services in the Securities Field*, 33 O. J. EUR. COMM. (No. C 42) 7 (1990) (Commission Notice No. 90/c 42/06) [hereinafter *Investment Services Directive*]. This directive has been subject to significant negotiation, and subsequent informal drafts have appeared.

### A. Certain Salient Features of U.S. Domestic Bank Regulation

U.S. domestic bank regulation has two main features that raise difficult issues for the world of international finance. These features were inspired by some of the abuses that are blamed for the Great Depression of 1929, and as in the securities area, the broad themes of U.S. bank regulation were established in the New Deal legislation of the early 1930s. Many now question their propriety when adopted, or their continuing validity, and they have been proposed to be modified significantly in the Treasury's recently proposed legislation.<sup>32</sup>

First, commercial banking—the business of taking deposits and making loans—is separated, to a diminishing but still significant extent, from both the securities business<sup>33</sup> and from most other areas of general commerce. Banking organizations cannot generally engage in securities underwriting or dealing, and securities organizations cannot generally engage in deposit-taking. Banking organizations also cannot generally own or be owned by commercial or industrial firms.<sup>34</sup> These regulatory themes of separation are increasingly questioned<sup>35</sup> as possibly over-re-

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<sup>32</sup> See Treasury Bill, *supra* note 20. The Treasury Report, *supra* note 19, recommends a number of important reforms, which would be implemented by the Treasury Bill. These include (a) nationwide banking, (b) permission for banking organizations to engage in new financial activities, (c) permission for commercial ownership of banking organizations, and (d) reform of deposit insurance that would involve a reduced scope for deposit insurance and capital-linked risk-based premiums for deposit insurance. These reforms all have important ramifications for international banking. An effort has been made to apply these reforms to the operations of foreign banking entities on a national treatment basis, but of course, given differences in home country regulation and banking structure, national treatment can amount to de facto discrimination. In addition, these reforms will affect the competitive position of U.S. banking organizations operating in foreign markets.

<sup>33</sup> See, e.g., Banking (Glass-Steagall) Act of 1933, 12 U.S.C. §§ 24, 377-378 (1988) (prohibiting banks from dealing in and underwriting securities, and limiting bank securities activities to agency activities upon the order of their customers) [hereinafter Glass-Steagall Act]. The Glass-Steagall Act has been the subject of extensive recent commentary, and is the subject of imminent reform. See, e.g., Norton, *Up Against "The Wall": Glass-Steagall and the Dilemma of a Deregulated ("Reregulated") Banking Environment*, 42 BUS. LAW. 327 (1987); Note, *The European Community's Second Banking Directive: Can Antiquated United States Legislation Keep Pace?*, 23 VAND. J. TRANSNAT'L L. 615 (1990). In addition, the Treasury Report, *supra* note 19, proposes relaxing the prohibitions of Glass-Steagall for certain well-capitalized banks.

<sup>34</sup> 12 U.S.C. § 24 (1988) (limiting the activities of banks to the business of banking) and 12 U.S.C. § 1843(a) (1988) (limiting the activities of and types of subsidiaries held by bank holding companies).

<sup>35</sup> The Bush administration has recently proposed a complete revision of the U.S. approach to this separation. Treasury Bill, *supra* note 20. In addition, there have been a number of smaller breaches in the Glass-Steagall wall. The most significant is the Board's approval of applications of bank holding companies under Section 20 of the Glass-Steagall Act, 12 U.S.C. § 377 (1988), to underwrite and deal in "ineligible" debt and equity securities. See, e.g., *J.P. Morgan & Co. Inc., et al.*, 75 Federal Reserve Bulletin 192 (1989). For a relevant discussion of developments under Section 20, see Eisenberg, *The Effect of Recent U.S. Bank Regulatory Developments on Accommodating Eu-*

strictive,<sup>36</sup> especially given the growing recognition of fungibility of bank finance and securities finance, as well as the growing involvement in financial sector activities by industrial companies. Simply put, as brokerage houses, insurance companies, auto and appliance manufacturers and other non-banks offer more and more products that compete with traditional bank services, it has become less realistic and fair to prevent banks from offering a broader range of financial and related services. On the other hand, the thrift crisis has underscored the need to be wary of deregulatory initiatives that may disturb the delicate balance between maintaining incentives for individual initiative and responsibility in bank management, and prudential regulation that protects the financial system and the federal safety net from excessive risk.<sup>37</sup>

Thus, in connection with its separation of banking from other businesses, the U.S. bank regulatory regime contains a significant and earnestly-held policy difference from many foreign regulatory regimes, including that of the Second Banking Directive, which adopts a universal banking structure, allowing banking organizations to engage in a wide range of securities business, as well as other business, including, subject to certain limitations, non-financial business.<sup>38</sup> This difference arises from a different economic and regulatory history, a different financial institution structure and a different regulatory, legal and political culture.

This difference raises two sets of issues in international finance: (i) when U.S. banking organizations operate abroad, to what extent are they still restricted by U.S. regulation that restricts their powers in order to guard their safety and soundness; and (ii) will foreign banking organizations that may engage in other businesses abroad that are not permitted to banking organizations in the U.S. be restricted in their access to the U.S. banking market? This is a conflict between two bases for prescriptive jurisdiction: territoriality and nationality. The U.S. applies its rules to its nationals (and their subsidiaries) wherever they operate, with some amelioration for foreign operations. It also applies its rules to foreign persons operating within the U.S. with respect to their U.S. operations *and* to a limited extent with respect to their operations abroad. Interna-

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*ropean Views of Appropriate Bank Securities Powers*, in 1992 IN EUROPE, A PRACTICAL AND LEGAL GUIDE TO DOING BUSINESS IN THE SINGLE EUROPEAN MARKET (1990).

<sup>36</sup> Insofar as the abuse to which they are addressed can be prevented by less restrictive measures.

<sup>37</sup> See, e.g., Gail & Norton, *A Decade's Journey From "Deregulation" to "Supervisory Reregulation": The Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 BUS. LAW. 1103 (1990).

<sup>38</sup> See text accompanying notes 69-95, *infra*. The Second Banking Directive does not require member states to permit banks to engage in the insurance business.



tional law provides little well-accepted restriction on exercise of jurisdiction on this type of overlapping basis. U.S. courts will look to the intent of Congress in order to determine whether Congress intended a particular statute to apply outside the U.S.<sup>39</sup> The Glass-Steagall Act itself contains no geographic limitation, nor does it or its legislative history contain any expression of an intent to cover overseas operations. The Supreme Court's recent analysis in *Boureslan v. Arabian American Oil Company* would indicate that, given the failure of Congress to express an intent to apply the Glass-Steagall Act abroad, it should not be so applied.<sup>40</sup> However, the BHC Act has provisions that indicate an intent to apply some of these principles to the operations of bank holding companies abroad, and Regulation K, formulated by the Board, responds to both sets of issues.

Second, commercial banks operating in the U.S. have been subjected to severe restrictions on interstate branching and other geographical expansion.<sup>41</sup> These restrictions stand in sharp contrast to the thrust of the Second Banking Directive toward extreme liberalization of geographic restrictions on competition in banking and financial services within the European Community. In effect, the European Community's single market has gone the U.S.' not-quite-single market one better, by creating a true single market in banking and financial services, while the U.S. so far continues to limit the ability of domestic banking organizations and foreign banking organizations to operate throughout the United States.<sup>42</sup>

## B. Regulation K

In April 1991, in response to concerns about the competitiveness of U.S. banking organizations in operations abroad, the Board revised Regulation K to permit U.S. banking organizations to expand the scope of their international activities. The Regulation K Revisions cover several

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<sup>39</sup> The Supreme Court, in *Boureslan v. Arabian American Oil Company*, 111 S. Ct. 1227 (1991), has recently held that certain statutory U.S. civil rights (under Title VII of the 1964 Civil Rights Act) are inapplicable to the activities of U.S. businesses operating abroad, as Congress did not evince sufficient intent that they be so applicable. This has been viewed by some commentators as a challenge to Congress to clarify the extraterritorial reach of these provisions.

<sup>40</sup> 111 S. Ct. 1227 (1991).

<sup>41</sup> McFadden Act, 12 U.S.C. § 36 (1988) (limiting branching by national banks). In addition, 12 U.S.C. § 1842(d) (1988), the "Douglas Amendment" to the BHC Act, imposes limitations on the ability of a bank holding company to acquire an out-of-state bank, unless permitted by the laws of the other state. The latter restrictions are made less problematic by state statutes that permit such acquisitions. See Shoenhair & Spong, *Interstate Bank Expansion: A Comparison Across Individual States*, in *BANKING STUDIES*, FEDERAL RESERVE BANK OF KANSAS CITY 1-23 (1990), for a description of various state laws regarding interstate banking.

<sup>42</sup> The Treasury Report, *supra* note 19, proposes extensive liberalization of restrictions on interstate banking.

areas. The areas that will be discussed here are (i) a liberalization of the authority of U.S. banking organizations to engage in underwriting and dealing equity securities abroad; and (ii) a clarification of the criteria for granting exemptions from the restrictions of U.S. banking law to certain foreign banking organizations operating within the U.S.<sup>43</sup> Under section 25 of the Federal Reserve Act,<sup>44</sup> the Edge Act<sup>45</sup> and the BHC Act, the Board is authorized to permit U.S. banking organizations to engage in a broader array of activities abroad than is permitted within the United States.

Foreign branches of U.S. banks are authorized, under section 25 of the Federal Reserve Act, to exercise such further powers as may be usual in connection with the banking business in the place where the branch is located, subject to the Board's regulation, and subject to statutory prohibitions on commercial and securities activities.<sup>46</sup> Edge Act subsidiaries of banks or of bank holding companies are permitted to engage in such activities as may be usual, in the determination of the Board, in connection with the business of banking or other financial operations in the countries in which they act.<sup>47</sup>

Section 4(c)(13) of the BHC Act<sup>48</sup> provides an exemption from the limitations on holding interests in non-banking organizations—the limitation on the businesses that a bank holding company may engage in through subsidiaries—imposed by Section 4 of the BHC Act for subsidiaries that do no business in the United States, if the Board determines by regulation or order that the exemption would not be “substantially at variance with the purposes of [the BHC Act] and would be in the public interest.”

Although the statutory standards for the exercise of the Board's discretion thus differ under each of these provisions, Congress clearly authorized the Board to make compromises between the goals of regulatory effectiveness—concerns for the integrity of the federal safety net—and competitiveness in connection with the foreign operations of U.S. banking organizations. It is notable that Congress gave little statutory guidance to the Board as to how to make this compromise. Under its own

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<sup>43</sup> In addition, the Regulation K Revisions include liberalization of investments by U.S. banking organizations under the general consent procedures (without specific Board approval), liberalization of foreign portfolio investments by U.S. banking organizations, and increasing the scope of entities to which Edge corporations may provide full banking services in the United States. *Regulation K Revisions*, *supra* note 4.

<sup>44</sup> 12 U.S.C. § 604(a) (1988).

<sup>45</sup> 12 U.S.C. §§ 611, 611(a) (1988).

<sup>46</sup> 12 U.S.C. § 604(a) (1988).

<sup>47</sup> 12 U.S.C. § 615(a) (1988).

<sup>48</sup> 12 U.S.C. § 1843(c)(13) (1988).

interpretation of these standards, set forth in Regulation K, the Board is permitted to authorize those activities that it finds to be "usual in connection with the transaction of banking or other financial operations abroad," so long as the activity is consistent with the safety and soundness of the relevant U.S. entities.<sup>49</sup> Regulation K articulates the Board's views as to what is permitted under this standard.

*1. Securities Activities of U.S. Banking Organizations Abroad under Regulation K*

Regulation K permits foreign subsidiaries of U.S. banks and bank holding companies to underwrite (purchase for resale in a primary securities offering) and deal (purchase for resale in secondary securities transactions) in debt and equity securities outside the United States, subject to certain limits on underwriting and dealing in equity securities.<sup>50</sup> In its release proposing the Regulation K Revisions, the Board recognized that these limits on underwriting and dealing in equity securities reduce the ability of U.S. banking organizations to compete abroad.<sup>51</sup> The Regulation K Revisions raise equity underwriting limits to the lesser of \$60 million or 25% of the investor's<sup>52</sup> Tier 1 capital.<sup>53</sup> The prior limit was the lesser of \$2 million or 20% of the voting shares or capital and surplus of any one issuer, although the use of multiple foreign underwriting subsidiaries could allow a banking organization on a consolidated basis to have commitments aggregating up to \$15 million.<sup>54</sup> The permission to engage in these activities abroad, subject to limits, represents a compromise between regulatory effectiveness and competitiveness. The expansion of the limits represents a change in the nature of the compromise.

The Glass-Steagall Act applies domestically without benefit of these exceptions, although it is increasingly subject to other exceptions. One immediate question is, if the separation of commercial banking from in-

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<sup>49</sup> *Regulation K Proposed Revisions*, *supra* note 4, at 96,677.

<sup>50</sup> *Regulation K*, *supra* note 4, at § 211.5(d)(13).

<sup>51</sup> *Regulation K Proposed Revisions*, *supra* note 4, at 96,678.

<sup>52</sup> The "investor" would be the bank holding company, an Edge corporation or a member bank, depending on which is the closest parent to the foreign company. Thus, where the investor is an Edge corporation, which is frequent, the limitations on the capitalization of the Edge corporation would limit its ability to engage in underwriting activities. Section 25(a) of the Federal Reserve Act limits member bank investments in Edge corporations in the aggregate to 10% of bank capital. 12 U.S.C. § 615(c) (1988). If a bank holding company were to invest directly in a foreign securities subsidiary, or in an Edge corporation, this limit would not apply.

<sup>53</sup> Tier 1 capital is defined in the Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure, 12 C.F.R. part 208, app. A (1991).

<sup>54</sup> The \$2 million or 20% of capital and surplus or voting shares of the issuer was contained in former § 211.5(d)(13). The ability to aggregate among multiple subsidiaries was limited by the investment limits under § 211.5(c)(1), requiring Board consent for investments exceeding \$15 million.

vestment banking is an important regulatory principle, why is it relaxed with respect to U.S. banking organizations' operations abroad? Competitive pressure is only part of the answer. The other part of the answer is that this regulatory principle is increasingly discredited. A principle that is increasingly recognized as subject to question, in part because it is not included in foreign regulation, is compromised at the international level in order to meet competitive pressure there.<sup>55</sup> Of course, the competitive pressure would exist at home as well, if U.S. regulation were not applied to foreign banking organizations operating in the United States to generally prevent them from engaging within the United States in businesses forbidden to U.S. banking organizations. Thus, while the safety and soundness rationale cannot support the application of these restrictions to foreign banking organizations operating in the U.S., it is important to apply these restrictions to these entities in order to avoid competitive unfairness to domestic banking organizations. Idiosyncratic domestic regulation thus leads to inapposite regulation of foreign entities to avoid competitive unfairness.

On the other hand, assuming it has been determined that allowing U.S. banking organizations to engage in the securities business abroad on a limited basis does not pose threats to the stability of the U.S. financial structure, not to mention the federal deposit insurance system, sufficient to overcome arguments based on competitive pressure, why does it matter where the activities are carried out? It may be that the Board feels it appropriate to limit its departures from its basic regulatory principle to the specific competitive circumstances—foreign operations—that justify the exceptions. In addition, the Board has stated that “decisions on the appropriate structure for broader powers for U.S. banking organizations should properly be made in a wider context.”<sup>56</sup>

There is a degree of asymmetry to the Board's position, insofar as it permits U.S. banking organizations increased powers in foreign markets, at the same time that it continues to deny these powers to foreign banking organizations operating in the United States. Thus, a foreign bank might question the fairness of a liberalization that benefits only U.S. banks operating abroad, and not foreign banks operating in the United States, when the principle being liberalized is just as applicable abroad as

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<sup>55</sup> See text accompanying notes 78-95 for a discussion of the pressures for domestic change arising from both (i) concerns that U.S. regulation is more restrictive than foreign regulation, and (ii) concerns that the U.S. does not offer effective national treatment or equivalent market access sufficient to satisfy requirements for reciprocity in connection with liberalization under the Second Banking Directive. As discussed therein, these pressures for deregulatory harmonization challenge long-held regulatory principles.

<sup>56</sup> *Regulation K Proposed Revisions*, *supra* note 4, at 97,692-93.

it is at home. In fact, it might argue that allowing a foreign banking organization to engage in securities activities in the United States poses less of a threat to the stability of the U.S. financial system and to the federal safety net than allowing U.S. banking organizations to engage in these activities abroad. It poses little more of a threat than permitting the foreign banking organization to engage in securities activities in its home market. The greater concern, and the motivation for applying these restrictions to foreign banks, is competitive equality with U.S. banking organizations.

*2. Activities of Foreign Banking Organizations in the United States under Regulation K*

Section 8(a) of the International Banking Act of 1978,<sup>57</sup> extends the restrictions on non-banking activities of the BHC Act to (i) any foreign bank maintaining a branch or agency in any state, (ii) any foreign bank or foreign company controlling a foreign bank that controls a commercial lending company organized under state law and (iii) any parent of any company referred to in clauses (i) or (ii). Sections 2(h)(2) and 4(c)(9) of the BHC Act provide for exemption of certain activities of foreign banking organizations from the BHC Act's prohibitions on non-banking activities. These provisions of the BHC Act are departures from national treatment intended in part to limit the extraterritorial effect on foreign banking organizations of the U.S. restrictions on the activities of banks. Thus, a foreign banking organization that engages abroad in activities that would not be permitted to a U.S. bank may, depending upon the nature of its foreign non-banking activities, nevertheless be permitted to operate in the United States. This is an example of what may be called "better-than-national treatment." That is, the foreign person operating in the United States is subject to a less restrictive U.S. regulatory regime outside the United States than the U.S. person outside the United States. This approach is the converse of the liberalization under Regulation K of the activities in which a U.S. banking organization may engage abroad, discussed above.

This form of reverse discrimination raises competitive concerns, but it is premised on two principles. The first principle is that the United States is most concerned about the soundness of its domestic banking organizations, as threats to the soundness of foreign banking organizations do not threaten the U.S. financial system or the federal safety net with the same magnitude as do threats to the soundness of domestic

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<sup>57</sup> 12 U.S.C. § 3106(a) (1988).

banking organizations. Of course, in an increasingly interdependent financial world, this principle has diminished validity. For example, U.S. money-center banks have extensive financial relations with foreign money-center banks, in the form of interbank deposits, interest rate and currency swap transactions and payment and clearance functions. Further, foreign banking organizations that take retail deposits in the United States are covered, with respect to those deposits, by the U.S. federal deposit insurance system.<sup>58</sup>

The second principle is one of comity, anticipation of reciprocity and recognition of the limits of U.S. prescriptive jurisdiction: a perception that the activity restrictions of the U.S. bank regulation regime should not generally apply to foreign activities of foreign persons on the mere basis of their engagement in permitted activities in the United States, and should not be a basis for excluding them from U.S. markets. Other countries have different approaches to bank regulation, and those other countries are entitled to implement their approaches on at least a territorial basis, without additional restrictions imposed by the United States. However, it should be recognized that this approach subjects the U.S. banking system to the risk that the foreign regulatory regime is insufficient, as a failure of the foreign banking organization with operations in the United States will have an adverse effect on the U.S. financial system, and may even implicate the U.S. deposit insurance system. In this sense, there is an implicit element of mutual recognition of home state regulation, accepting home state regulation as reasonably adequate to justify the acceptance of these risks, despite its differences from U.S. regulation.

From the home country's perspective, and as fully recognized by the European Community, this is a trade issue.<sup>59</sup> From this perspective, U.S. refusal of entry to a foreign banking organization that engages at home in activities that do not fit within U.S. regulatory conceptions of "banking" would be a non-tariff barrier to trade in services. The primary purpose of the Second Banking Directive is to eliminate such barriers within the European Community; a secondary purpose, which is sought through the use of the reciprocity provisions of the Second Banking Directive, is to reduce such barriers to European Community banking organizations

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<sup>58</sup> 12 U.S.C. § 3104 (1988) requires that U.S. branches of foreign banks carry Federal Deposit Insurance Corporation deposit insurance if they accept significant retail deposits. U.S. bank subsidiaries of foreign banking organizations would be subject to the general requirements for Federal Deposit Insurance Corporation deposit insurance coverage. See, e.g., 12 U.S.C. § 1814(b) (1988).

<sup>59</sup> For a discussion of the GATT context, see, e.g., Zavvos, *supra* note 30, at 501, and the *Draft Sectoral Annex on Financial Services Presented Under Canadian Sponsorship at General Agreement on Tariffs and Trade Talks in Brussels*, 7 INT'L TRADE REP. (BNA) 1854 (Dec. 5, 1990).

outside the European Community. From the U.S. perspective, Regulation K seeks unilaterally to reduce such barriers, but only to a limited extent.

In order to do so, Section 211.23 of Regulation K provides exemptions from certain U.S. restrictions to "qualifying foreign banking organizations" (QFBOs). These exemptions articulate the provisions of Sections 2(h)(2) and 4(c)(9) of the BHC Act, discussed in more detail below. A QFBO is a foreign banking organization whose non-U.S. banking business (based on at least two out of three of its assets, revenues and net income) is greater than its worldwide non-banking business *and* whose foreign banking business is greater than its U.S. banking business. The essential thrust of the test is to determine whether the foreign banking organization is primarily a "bank" in its operations abroad, and has the greater part of its banking operations abroad. Thus, entities that are not banks by the specified standards, or that conduct the greater part of their banking operations within the United States, would not be QFBOs. The second prong of this test has an obvious rationale: if entities with primarily U.S. banking businesses are permitted exemptions from the restrictions of the BHC Act in their operations abroad, in addition to those set forth in Regulation K, then the BHC Act will soon be eviscerated. While such evisceration may appear desirable to some, it cannot be acceptable from the standpoint of the Board, as it would be inconsistent with the clear intent of Congress and the expressed responsibilities of the Board.

The first prong—requiring that the foreign banking organization be primarily a bank in its operations abroad—is more interesting. Its test is regulo-centric<sup>60</sup> insofar as U.S. standards under Section 211.5(d) of Regulation K itself are used to determine which foreign activities are included within "banking." While Section 211.5(d) purports to be a list of activities that are "usual in connection with the transaction of banking or other financial operations abroad," it would be more accurate to describe it as a list of activities that the Board has determined to be permissible for U.S. banking organizations operating abroad. It by no means represents an international consensus on what activities are appropriate for banks, and thus may disadvantage foreign entities with substantial activities that are not included on the list, but nevertheless consider themselves banks. Moreover, it was originally intended as a means to allow U.S. banks to compete in foreign markets, while limiting the risks to the U.S. banking system from these liberalized powers, whereas it is used in this

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<sup>60</sup> This word is used to mean that the test regards the world through the prism of U.S. regulation, without taking account of other states' policies or regulation.

context as a means of limiting the operations abroad of foreign banks. Although the use of this standard has a certain unilateral transnational symmetry—requiring the foreign activities of foreign persons engaged in U.S. banking to conform to some extent to the activities permissible to U.S. banking organizations operating abroad—it might be viewed by foreign banking organizations as an unjustified projection abroad of U.S. regulatory principles. In this context, it is appropriate to consider the possible regulatory rationales for this prong of the test for QFBO status.

Section 2(h)(2) of the BHC Act provides an exemption from the prohibitions of Section 4 of the BHC Act—which limits interests held by bank holding companies in non-banking organizations—for acquisitions of foreign companies principally engaged in business outside the United States by foreign bank holding companies that are principally engaged in the banking business outside the United States. Section 2(h)(1), which is subject to Section 2(h)(2), otherwise purports to extend the application of the BHC Act generally to transactions outside the United States and to companies organized outside the United States.

Section 4(c)(9) exempts from the prohibitions of Section 4:

[S]hares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of this chapter and would be in the public interest.

Thus, while Section 2(h)(2) seems to support the requirement that the foreign banking organization be principally engaged in banking (without specifying a definition of banking), Section 4(c)(9) provides wide authority for the Board to exempt foreign companies principally engaged in foreign business from the restrictions of Section 4. As with the provisions of the BHC Act forming the basis for the Regulation K provisions permitting U.S. bank holding companies to engage in a wider range of activities abroad than in the United States, Sections 2(h)(2) and 4(c)(9) and the rules thereunder evince legislative abdication and regulatory arrogation of the power to decide how far U.S. bank regulation will extend abroad.

As discussed above, the Board, in Regulation K, has exercised this power to limit its exemption to those foreign companies that are principally engaged abroad in “banking”. No specific definition is provided for banking, but Section 211.23(c)(2) of Regulation K refers to the list of activities contained in Section 211.5(d) as included within the term “banking” when conducted within the foreign banking organization by a foreign bank or its subsidiaries. The Board has promulgated the list con-



tained in Section 211.5(d) on the basis of its interpretation of the purposes of the BHC Act and the public interest. However, this limitation may block access to the U.S. market by foreign "universal" banks, which may derive a significant portion of their business from other activities, such as securities or insurance.<sup>61</sup> With the implementation of the Second Banking Directive, which will come into force by the end of 1992, more European banks will be universal banks,<sup>62</sup> and it is expected that more merger activity will take place among European financial institutions. These two phenomena combined will increase the difficulties arising from the application of U.S. restrictions to the foreign business of foreign financial firms that do business in the United States.

In connection with its initial proposal of the Regulation K Revisions, the Board expressed concern that increasing foreign merger activity might increasingly cause a foreign banking organization that otherwise met the QFBO test to fail to meet the QFBO test.<sup>63</sup> For example, a foreign banking organization with U.S. banking operations that previously met the QFBO test might be acquired by a foreign non-life insurance company, on which basis the foreign banking organization might no longer satisfy the QFBO requirements. The QFBO test includes a wrinkle that makes this circumstance more likely to result in disqualification as a QFBO than might otherwise be the case. It only allows to be counted as foreign *banking* activity those activities conducted by the foreign bank<sup>64</sup> or a subsidiary of the foreign bank.<sup>65</sup> Thus, if a foreign life insurance company acquires a foreign bank, even though life insurance is added by the Regulation K Revisions to the Section 211.5(d) list,<sup>66</sup> its life insurance business would not be included in foreign

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<sup>61</sup> The Regulation K Revisions have added certain life and other related insurance underwriting to the list of permissible activities.

<sup>62</sup> See, e.g., Zavvos, *supra* note 30, at 480-81.

<sup>63</sup> *Regulation K Proposed Revisions*, *supra* note 4, at 96,684.

<sup>64</sup> According to the definition provided in § 211.2(j) of Regulation K, which appears to be applicable, "foreign bank" means a company organized abroad that engages in the business of banking; is recognized as a bank by the bank supervisory or monetary authority of the country of its organization or principal banking operations; receives deposits to a substantial extent in the regular course of its business; and has the power to accept demand deposits. This definition is relatively regulo-centric, and could exclude companies that engage in activities outside the scope of banking as defined in the U.S., but within the scope of banking as defined abroad. On the other hand, "foreign bank" as defined in Section 1(b)(7) of the International Banking Act of 1978, 12 U.S.C. § 3101(7) (1988) is a much more accommodating concept. The latter definition refers to companies organized abroad that engage in the business of banking, *or any subsidiary thereof*, including, "without limitation, foreign commercial banks, foreign merchant banks and other foreign institutions that engage in banking activities. . . in the countries where such foreign institutions are organized or operating" (emphasis added). Such a definition would eviscerate § 211.23(c)(2).

<sup>65</sup> *Regulation K*, *supra* note 4, § 211.23(c).

<sup>66</sup> *Regulation K*, *supra* note 4, § 211.5(d)(16).

banking business for purposes of the QFBO test. In fact, its life insurance business would be included in non-banking activity for purposes of the test. This structural bias in favor of holding businesses of the type described in Section 211.5(d) of Regulation K within a foreign bank (as restrictively defined in Regulation K), or in the bank's subsidiaries, appears relatively artificial, insofar as the outcome of the QFBO test may be changed by moving appropriate operations into the bank chain of ownership.

In response to what it refers to as possible undue hardship arising from the strict application of the QFBO test,<sup>67</sup> under the revised Regulation K, the Board plans to grant exemptions, including prospective exemptions, for failure to meet the QFBO test on a case-by-case basis.<sup>68</sup> It would exercise this discretion in order to prevent hardship to foreign companies, considering whether the non-qualifying owner engages predominantly in activities permissible to U.S. bank holding companies abroad. This discretion would allow the Board to ameliorate the operation of Section 211.23(c)(2), which requires that non-banking operations be conducted through or under the foreign bank, in order to help establish QFBO status.

Of course, a foreign banking organization that can qualify for this type of discretionary exemption would be grateful for it. However, a change that the Board declined to make would have diminished the need for discretionary exemptions without sacrificing important policies. This change would allow all operations of the foreign banking organization to be considered in determining whether QFBO status is available. This would simplify and rationalize the regulatory standard. However, this revision would not eliminate the problem of a unilateral, regulo-centric approach to the operations of foreign banking organizations outside the United States.

### C. The Relationship Between Regulation K and the Second Banking Directive

#### 1. *The Second Banking Directive*

The Second Banking Directive is central to the recent European Community legislation to liberalize financial services, both geographically within the European Community and functionally, helping to create the single market in this service sector.<sup>69</sup> Even more importantly,

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<sup>67</sup> See *Regulation K Proposed Revisions*, *supra* note 4, at 96,700.

<sup>68</sup> *Regulation K*, *supra* note 4, § 211.23(e).

<sup>69</sup> The preamble to the Second Banking Directive calls it "the essential instrument for the achievement of the internal market, a course determined by the Single European Act and set out in

this liberalization is expected to be a major factor in the implementation of the free movement of capital. It is based on the principle of integration through the blended approach of minimal or "essential" harmonization of necessary regulations, and mutual recognition of home country licensing and supervision.<sup>70</sup> This section will briefly describe the Second Banking Directive and explain its approach to extraterritoriality and reciprocity and will then proceed to examine the interaction of Regulation K and the Second Banking Directive. This examination has a two-fold purpose: first, to understand the approach to harmonization taken within the European Community, aided by an institutional and constitutional infrastructure that enables enhanced cooperation toward harmonization; and second, to understand the approach taken by the Second Banking Directive to third country banks. Thus we look at the European Community as a multinational organization from an internal perspective, and as a unitary entity from an external perspective.

The mechanics of the Second Banking Directive are relatively simple. Credit institutions that are authorized to engage in business in one member state are entitled to engage in authorized businesses<sup>71</sup> in all other member states of the European Community, both through interstate branching and through cross-border services. No local authorization or local capital may be required by the other member states: this is the "single banking license".

The principle of integration followed by the Second Banking Directive—essential harmonization and mutual recognition—is the cornerstone of the integrative thrust under the Single European Act of 1986.<sup>72</sup> This principle has been found more effective in terms of legislative productivity than the more difficult approach of complete harmonization. It also has obvious advantages over mere mutual recognition in terms of regulatory effectiveness: it allows some commonly agreed regulatory goals to be achieved uniformly and transnationally, instead of relying

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timetable form in the Commission's White Paper, from the point of view of both the freedom of establishment and the freedom to provide financial services, in the field of credit institutions." *Second Banking Directive*, *supra* note 30.

<sup>70</sup> See Zavvos, *supra* note 30, at 470-76. The two main pure approaches to integration are (i) agreeing on private international law rules to determine which country's law will govern a particular person, circumstance or transaction, and (ii) unifying laws so that each country's law is the same as each other country's law, making it unimportant which country's law governs.

<sup>71</sup> The permitted activities are listed in the annex to the Second Banking Directive, *supra* note 30, and include a wide range of activities, including deposit-taking, lending, leasing, credit cards, foreign exchange trading, futures and options trading, securities trading, underwriting, investment banking advice, etc. They do not include insurance.

<sup>72</sup> Single European Act, 30 O.J. EUR. COMM. (No. L 169) 1 (1987); 3 COMMON MKT. REP. (CCH) ¶ 21,000.

solely on the vagaries of national regulation, as influenced by competition in regulatory laxity.

The Second Banking Directive's common regulatory standards include (i) minimum capital<sup>73</sup> of five million ECU (with possible exceptions);<sup>74</sup> (ii) restrictions on participation in non-credit or non-financial institutions;<sup>75</sup> (iii) supervisory control over major shareholders;<sup>76</sup> and (iv) requirements for "sound administrative and accounting procedures and adequate internal control mechanisms."<sup>77</sup>

However, despite the ability to achieve commonly agreed regulatory goals, this approach otherwise has a qualified deregulatory thrust. The deregulatory thrust arises from the fact that national regulatory burdens imposed in excess of the commonly agreed minimum standards may act as a competitive disadvantage to national competitors, resulting in a competitive national regulatory "race for the bottom" or "competition in regulatory laxity". This phenomenon is qualified by the fact that national regulation that enhances the competitive position of national competitors, such as regulation, surveillance and enforcement that makes them more attractive depositories at a cost to them less than the profit they can earn on the resulting increased business, would provide competitive benefits to the regulated persons. Subject to this qualification, the Second Banking Directive may result in progressive reduction of national regulation to the extent that it exceeds the standards set in the Second Banking Directive.

## 2. *The Reciprocity Requirement of the Second Banking Directive*

The Second Banking Directive is a market-opening initiative, resulting in extreme liberalization of geographic restrictions on banking services within the European Community. As with other European Community market-opening initiatives, the question arises whether the European Community will allow non-Community competitors to enjoy the benefits of the liberalization.<sup>78</sup> The European Community has not

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<sup>73</sup> As defined in the *Own Funds Directive*, *supra* note 30.

<sup>74</sup> *Second Banking Directive*, *supra* note 30, at art. 4.

<sup>75</sup> *Id.* at art. 12.

<sup>76</sup> *Id.* at art. 11.

<sup>77</sup> *Id.* at art. 13.

<sup>78</sup> The Second Banking Directive does not change the basic regime with respect to branches of foreign banks, which is governed by the First Banking Directive, *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*, 20 O.J. EUR. COMM. (No. L 322) 30 (1977) (Council Directive 77/780/EEC) [hereinafter *First Banking Directive*]. Articles 4 and 9 of the First Banking Directive permit member states to require foreign banks to obtain a license before

been altogether consistent on this issue,<sup>79</sup> but has often sought a quid pro quo—some form of reciprocity—in exchange for third country access.<sup>80</sup> The Second Banking Directive is no different, as it imposes a requirement for reciprocity by the home country of a foreign parent company, in order for a European Community subsidiary of that foreign parent company to be permitted the benefits of the Second Banking Directive.

What does “reciprocity” mean? This is a critical issue, and caused a good deal of concern in the United States when the Second Banking Directive was first proposed.<sup>81</sup> The two poles are between (i) reciprocal national treatment, whereby foreign persons are required to be treated precisely the same as domestic persons, and (ii) so-called “mirror image” reciprocity, whereby a foreign person is permitted to do the same things in the host country as host country nationals are permitted to do in the territory of the foreign person’s home country. Reciprocal national treatment requires no *territorial* regulatory concessions, other than with respect to vestigial access regulation, and is therefore an easier standard for the United States or Japan to meet. It does not entail making exceptions to the domestic application of restrictive rules like the separation of commercial and investment banking, or, in the United States, the separation of banking from commerce and limitations on interstate banking.

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establishing a branch. The 19th “whereas” clause of the Second Banking Directive specifies that the First Banking Directive will continue to govern in this regard.

<sup>79</sup> Article 58 of the Treaty of Rome mandates the right of establishment throughout the Community for firms incorporated under the laws of member states. It does not specifically discriminate against such firms the shareholders of which happen to be third-country corporations or nationals, and the European Commission generally applies article 58 to all firms formed under the law of a member state. However, the right of first establishment—of forming a firm under member state law or purchasing one—is potentially restricted for third-country corporations or nationals, under sector-specific regimes like the Second Banking Directive. Rome, Treaty Establishing the European Economic Community, March 25, 1957, 298 U.N.T.S. 11g.

<sup>80</sup> Third-country firms and governments have expressed concern about whether the creation of the internal market for the European Community involves the creation of a “Fortress Europe” against third-country trade. In 1988, the Commission explained that, while it expected trade-creation effects to benefit third countries, and while it would comply with its GATT and other trade obligations, it would “not unilaterally extend the benefits of internal liberalization to third countries. Instead, the EC will seek comparable liberalization on the part of its major trading partners.” Commission of the European Communities, “Europe 1992—Europe World Partner,” European Community News Release 28188 (EC Office of Press and Public Affairs, Oct. 19, 1988).

<sup>81</sup> *Proposal for a Second Council Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking-Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC*, 31 O.J. EUR. COMM. (No. C 84) art. 7 at 1 (1988) (Commission Notice No. 88/C 84/01) [hereinafter *Proposed Directive*]. See Gruson & Nikowitz, *The Second Banking Directive of the European Economic Community and Its Importance for Non-EEC Banks*, 12 FORDHAM INT’L L.J. 205 (1989), and Gruson, *The Second European Banking Directive*, 5 REV. BANKING & FIN. SERV. 159 (erroneously dated September 13, 1989, but actually published Spring 1990).

While the International Banking Act of 1978<sup>82</sup> incorporated the concept of national treatment, there are questions regarding the extent to which restrictions such as the QFBO standard discussed above<sup>83</sup> undermine the principle of national treatment for European Community banking organizations in the United States.<sup>84</sup>

Mirror image reciprocity, on the other hand, may be viewed as a variation on 19th century concepts of "extraterritoriality," under which foreign nationals remain subject to their home country's law, and are protected from the operation of their host country's law, despite their physical presence in the host country.<sup>85</sup> It would in practice require the United States to become a party to the Second Banking Directive. It would require the United States to permit European Community banking organizations to engage within the U.S. in the full range of activities permitted to U.S. banking organizations operating in the European Community under the Second Banking Directive. If the U.S. did so without liberalizing the rules applicable to U.S. banking organizations in the U.S., it would provide significant competitive advantages to European Community banking organizations in their U.S. operations: better-than-national treatment. U.S. banks would obviously find this unacceptable for competitive reasons, and U.S. regulators would find some of their most dearly-held principles, as well as the principles they would like to abandon, violated by the foreign entrants.

The Proposed Directive specified neither national treatment nor mirror image reciprocity, but did provide a requirement for reciprocity. If the Commission found that reciprocity was not available in the home country of a non-European Community person seeking to establish a banking subsidiary in the European Community, it could suspend its application.<sup>86</sup> The ambiguity of this provision, and its possible offensive use, caused concern in the United States. The provision was amended in

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<sup>82</sup> 12 U.S.C. § 3101 *et seq.* (1988).

<sup>83</sup> See text accompanying notes 57-68, *supra*.

<sup>84</sup> For a list of potential exceptions to national treatment, see U.S. General Accounting Office, *International Finance: Competitive Concerns of Foreign Financial Firms in Japan, the United Kingdom, and the United States* 21-25 (1988). See also the Schumer Amendment under the Omnibus Trade and Competitiveness Act of 1988, 22 U.S.C. §§ 5341-5342 (1988), which requires that the Board determine whether U.S. firms are granted the same competitive opportunities as domestic firms in the home country of a firm seeking or holding primary dealer status for U.S. government securities.

<sup>85</sup> Extraterritoriality in this sense is the mostly past practice of Western countries negotiating treaties with former colonies or other Asian or Middle Eastern countries whereby the Western country's nationals would be exempt from local law. See Bederman, *Extraterritorial Domicile and the Constitution*, 28 VA. J. INT'L L. 451 (1988).

<sup>86</sup> *Proposed Directive*, *supra* note 81, at art. 7(6).

order to respond to these concerns, but the ground for concern has not been completely eliminated.

The Second Banking Directive incorporates both concepts of reciprocity, providing for different potential European Community reactions depending on the type of reciprocity that is found to be denied by the relevant third country.

Under Article 9(3), if "effective market access comparable to that granted by the Community to credit institutions from that third country"—a flexible mirror image reciprocity standard—is denied, the European Commission may merely request of the Council a mandate to negotiate with that third country for "comparable competitive opportunities."<sup>87</sup> While this process may be effective, and may carry with it the implicit threat of retaliation should negotiations break down, it is not as threatening as the process to be invoked if the Commission finds that national treatment is denied. This process might be invoked, for example to call for interstate banking rights in the United States to be accorded to Community credit institutions.

Under Article 9(4), if national treatment *offering the same competitive opportunities as those available to domestic credit institutions* is denied to European Community banking organizations, *and the conditions of effective market access are not fulfilled*, the Commission may initiate negotiations *and* suspend applications for permission from corporations formed under the laws of the offending country to establish banking subsidiaries in the European Community.<sup>88</sup> The first part of this trigger is a national treatment standard, assuming that "domestic credit institutions" refers only to U.S. banks, and not to banks plus other financial services firms. If the earlier italicized language adds anything to the national treatment standard—and one must assume that it is intended to—it means that *de facto* exclusion or limitation of European Community banking organizations, for example, because they generally fail to meet the QFBO test, is unacceptable. The additional prong relating to the conditions of effective market access appears to refer back to Article 9(3), with its call for comparable market access. Apparently, even if national treatment is not offered, if comparable market access is offered, the sanctions under Article 9(4) will not apply. In short, Article 9(3) contains a mirror image reciprocity standard, while Article 9(4) refers to national treatment.

Based on the current regulatory structure in the United States, it is possible that the national treatment standard of Article 9(4) could be

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<sup>87</sup> *Second Banking Directive*, *supra* note 30, at art. 9(3).

<sup>88</sup> *Second Banking Directive*, *supra* note 30, at art. 9(4).

invoked, with the application of significant sanctions against the U.S., although Japan may be the more likely target. While U.S. commentators have expressed a degree of satisfaction with the final reciprocity provisions of the Second Banking Directive,<sup>89</sup> it is clear that the U.S. will continue to be subject to pressure from the European Community to reduce some of its regulatory constraints that affect European Community banking organizations seeking to operate in the United States.<sup>90</sup>

### 3. *Interaction Between Regulation K and the Second Banking Directive*

Let us now return to Regulation K, the U.S. unilateral administrative moderation of the extraterritorial application of the BHC Act. It moderates such application both from the standpoint of U.S. banking organizations operating abroad, and from the standpoint of foreign banking organizations operating in the United States. While these aspects of Regulation K are nominally separate, they are linked by certain concepts, and, in a sense, by the Second Banking Directive itself. Together, Regulation K and the Second Banking Directive form a regulatory echo chamber that creates opportunities for interesting reverberations.

First, consider how Regulation K affects the determination of national treatment to European Community firms operating in the United States. The QFBO standard of Section 211.23 of Regulation K operates as an access limitation on the ability of European Community firms to engage in banking business within the United States.<sup>91</sup> Does this limitation prejudice national treatment? From the U.S. perspective, it may not, as it merely provides a special exemption to foreigners from some of the normally applicable restrictions under the BHC Act: the U.S. might argue that this is "better-than-national treatment."

From a foreign perspective, however, it may be viewed as imposing *de facto* barriers to European Community credit institutions. These barriers might indicate that the United States fails to offer "national treatment offering the same competitive opportunities as are available to domestic credit institutions", also failing to fulfill "the conditions of effective market access" within the meaning of Article 9(4) of the Second Banking Directive. From this perspective, European Community firms are denied access *because* of their use of their greater powers abroad, a use which is both permitted by their home countries and necessitated by

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<sup>89</sup> Gruson, *The Second European Banking Directive*, 5 REV. BANKING & FIN. SERV. 159, 167 (erroneously dated September 13, 1989, but actually published Spring 1990).

<sup>90</sup> See Zavvos, *supra* note 30, at n. 203.

<sup>91</sup> See text accompanying notes 57-68, *supra*.



competition abroad. Will the European Community allow the United States to require European Community firms to abide by U.S. regulatory restrictions in Europe in order to maintain access to the United States, or will the U.S. accept the more liberal European Community regime? It is useful to refer to the regulatory purpose sought to be served by the QFBO standard.

One purpose of the QFBO standard is to prohibit access to the U.S. banking market by firms that engage in businesses held by our regulatory principles to pose excessive risk.<sup>92</sup> However, the United States has shown an increasing willingness to compromise these regulatory principles, both domestically and in connection with the operations of U.S. firms abroad. It may be difficult for the European Community to understand why the United States holds the line as applied to the foreign activities of foreign firms, when it is liberalizing for the foreign activities of domestic firms.

A second purpose of the QFBO standard is to provide a level playing field within the United States, so that foreign firms that make use of wider powers and activities abroad are prevented from competing within the United States. This latter reason may raise concerns from the foreign standpoint, as it levels the playing field extraterritorially in order to level the playing field domestically. That is, it not only limits the activities of European Community firms in the United States, but also limits the activities of European Community firms abroad. Thus, considering both purposes of the QFBO standard, the European Community might find it difficult to agree that *de jure* better-than-national treatment does not amount to *de facto* less-than-national treatment.

Second, consider how Regulation K affects the determination of whether European Community firms are accorded "effective market access comparable to that granted by the Community" to U.S. banking organizations, within Article 9(3) of the Second Banking Directive. Regulation K allows U.S. banking organizations to engage in a wider range of activities in the European Community than would be permitted within the United States, including limited equity securities underwriting and dealing, certain lease financing and certain insurance activities.<sup>93</sup> All these activities (other than possibly insurance) and more would be permitted under the Second Banking Directive, assuming the subsidiary is

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<sup>92</sup> It should be noted that the relative magnitude of risk posed by the securities business, or other businesses divorced from commercial banking in the U.S., is difficult to quantify empirically. In addition, it might be argued that a portfolio of financial service businesses, including commercial banking and investment banking, as well as others, would be less volatile than a single one of these businesses alone. More importantly, of course, the risk of any business depends on how it is done.

<sup>93</sup> *Regulation K*, *supra* note 4, at § 211.5(d).

first admitted to a member state of the European Community.<sup>94</sup> However, European banking organizations operating in the United States would not be permitted to engage in these activities to the same extent as they are permitted to in Europe. One response to this phenomenon is that it does not raise problems, but is the nature of the world. Mere difference of national law, with no protectionist motivation, does not prejudice effective market access *in unacceptable ways*.

However, a different perspective might consider that the United States was failing to provide European Community firms with access to U.S. markets comparable to the access that the European Community provides to U.S. firms. There are two bases for this perspective. First, European Community firms would not be permitted to engage in the United States in the full range of services that U.S. firms are permitted to perform in Europe. This is merely because Europe has a more liberal internal regime than the outmoded U.S. regulatory regime, but it results in greater market access to U.S. firms in Europe than that accorded European firms in the United States. Second, U.S. firms are not disadvantaged in terms of their access to the European Community market on the basis of a regulatory restriction that would limit their activities in the United States, whereas the QFBO standard has this extraterritorial effect on European Community firms seeking access to the U.S. banking market.

Finally, although they do not arise under Regulation K, we should consider here the effects of restrictions on interstate banking in the United States. These restrictions limit the access of European Community firms to the U.S. national banking market, while under the Second Banking Directive and under general European Community law,<sup>95</sup> the goal and effect is to achieve a single, Community-wide market. They might be viewed as inconsistent with access comparable to that provided in the European Community to U.S. firms, raising issues under Article 9(3) of the Second Banking Directive.

Thus, if the European Community persists in criticizing U.S. regulation on the basis of its creation of *de facto* barriers, pressuring the United States to engage with the Community in a process of reciprocal reduction of barriers, it will be engaging in an external process that bears some similarity to its internal process of essential harmonization and mutual recognition. However, instead of essential harmonization in the sense of establishing minimal regulatory standards, it engages with the United

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<sup>94</sup> *Second Banking Directive*, *supra* note 30, at annex.

<sup>95</sup> See, e.g., the German Insurance Case, *Commission v. Germany*, Case 220/83, 2 COMMON MKT. L.R. 69 (1987).

States in harmonized reduction of regulatory standards, perhaps with the implicit assumption or evaluation that U.S. regulatory standards are at a high enough level. Instead of mutual recognition of U.S. banking licenses, it allows U.S. banking firms to obtain Community banking licenses. While the internal Community process and the external negotiation with the United States are different, they have the same trade effect: establishing a reasonably barrier-free market in financial services that includes the United States.

This conflict may be viewed in terms of prescriptive jurisdiction. In these terms, the U.S. is seeking to apply its restrictive regime to European Community firms that operate in the United States, in connection with their operations in Europe. The basis for U.S. prescriptive jurisdiction over the European activities of these firms is their U.S. operations, which may be analogized to U.S. residence, as well as the effects that their activities have within the United States, both on their customers and their competition. On the other hand, the European Community's basis for prescriptive jurisdiction is nationality and residence, as well as the effects their activities have within the Community, including the ability of the Community to establish globally competitive financial institutions. Thus, overlapping jurisdiction is based on dual residence and effects in both jurisdictions. Is there any way to divide up prescriptive jurisdiction so that only a single financial institutional regulation regime governs the operations of European financial conglomerates? International law provides no rules of decision to answer this question for us, so we must look to the practical realities in order to determine whether an allocation of prescriptive jurisdiction can be definitively negotiated. This is the technical legal context of the trade negotiation. Within the European Community, the issue of prescriptive jurisdiction has been addressed as a trade issue. The United States has not yet fully viewed it this way, but this perspective is changing.

#### D. Rule 15a-6 and the Broker-Dealer Concept Release

Like the QFBO provisions of Regulation K, Rule 15a-6<sup>96</sup> represents a unilateral U.S. administrative approach to foreign financial institutions operating in the United States. However, it is the product of a different statutory context and regulatory process from the one that produced

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<sup>96</sup> Rule 15a-6 under the Exchange Act, 17 C.F.R. § 240.15a-6 (1988), was adopted in Exchange Act Release No. 27,017, [1989 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,428 (July 11, 1989) [hereinafter *Rule 15a-6 Release*]. At the same time, the Commission issued a broader "concept release" on the topic, Recognition of Foreign Broker-Dealer Regulation, Exchange Act Release No. 27,018, [1989 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,429 (July 11, 1989) [hereinafter *Broker-Dealer Concept Release*].

Regulation K, as Regulation K in this context is the Board's interpretation and amplification of U.S. banking law, while Rule 15a-6 is the Commission's effort to fill a void in U.S. securities law. It is even the product of a different statutory context and regulatory process from Regulation S, discussed below,<sup>97</sup> as it is a product of the Division of Market Regulation of the Commission, which is concerned in this context with regulation of broker-dealer professionals, while Regulation S is a product of the Division of Corporate Finance of the Commission, which is concerned in this context with requirements for timing and extent of disclosure by issuers of securities. Rule 15a-6 deals with the question of the applicability of U.S. broker-dealer registration requirements and regulation to foreign persons. It was promulgated simultaneously with a broader "concept release" on mutual recognition of foreign broker-dealer regulation, which will be discussed in greater detail below.

The regulatory purpose of the registration requirement is to protect investors and to protect the integrity of the market by (i) establishing qualification standards for broker-dealers and their personnel, (ii) establishing rules of conduct, antifraud standards and enforcement mechanisms, (iii) establishing net capital requirements, and (iv) imposing recordkeeping and reporting obligations.<sup>98</sup> These protections are viewed as critical to the maintenance of the integrity and efficiency of the U.S. securities market. Despite the prudence of these rules, foreign broker-dealers would generally prefer not to be subject to them. They entail certain additional costs of doing business that these enterprises might not otherwise choose to incur. An important example is the net capital rule<sup>99</sup> applicable to U.S. broker-dealers, which requires that U.S. broker-dealers maintain a certain level of assets, subject to volatility-based discounting,

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<sup>97</sup> See text accompanying notes 147-173, *infra*.

<sup>98</sup> As pointed out by the Commission, many of these rules do not actually require broker-dealer registration in order to apply to foreign broker-dealers. The Commission states that its staff would not recommend enforcement action in case a foreign broker-dealer exempt from the registration requirement under Rule 15a-6 fails to comply with other rules applicable to broker-dealers using the jurisdictional means. *Rule 15a-6 Release*, *supra* note 96, n. 22 at 80,235. This position is curious, insofar as it leaves foreign broker-dealers less than certain that they will not be subject to these ancillary enforcement actions. A no-action position taken by the staff of the Commission is not necessarily binding on the Commission itself, and more importantly, does not bind individuals who may, or may not, have a private cause of action. This position is probably based on limitations of the Commission's statutory rule-making authorization, which might be required to be increased in order to exempt foreign broker-dealers from these other requirements. Of course, the Commission could promulgate rules under § 30(b) of the Exchange Act, but may be reluctant to do so because such rules would rehabilitate § 30(b), or because such rules would necessarily exempt foreign broker-dealers from the antifraud provisions of the Exchange Act, a result that would be unacceptable to the Commission.

<sup>99</sup> Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1990).

in relation to their liabilities. The net capital rule may be compared to the proposals contained in the European Community's proposed Capital Adequacy Directive<sup>100</sup> and to the proposals discussed in the forum of the International Organization of Securities Commissions (IOSCO).

Rule 15a-6 was first proposed in 1988.<sup>101</sup> It is intended to clarify or to moderate the jurisdictional reach of Section 15(a) of the Securities Exchange Act of 1934,<sup>102</sup> which specifies that any broker or dealer using any means of interstate commerce<sup>103</sup> to sell securities must register with the Commission. The Commission is authorized under Section 15(a)(2) of the Exchange Act to conditionally or unconditionally exempt any broker or dealer from the registration requirements of Section 15(a).

The Rule 15a-6 Proposing Release describes the development of the Commission's position on this issue, beginning with Release 4708.<sup>104</sup> The staff of the Commission believes that "in contrast to the more expansive scope of the antifraud provisions [Section 10(b) of the Exchange Act and Rule 10b-5 thereunder], the U.S. broker-dealer registration requirements were not intended to protect foreign persons dealing with foreign securities professionals outside the United States."<sup>105</sup> Putting aside for a moment the question of how the Commission divined Congress' intent so specifically, according to this territorial approach, where foreign investors trade through foreign broker-dealers outside the United States, the broker-dealer registration requirements should not be applied. In addition, where a foreign broker-dealer effects *unsolicited* trades for U.S. in-

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<sup>100</sup> *Proposal for a Council Directive on Capital Adequacy of Investment Firms and Credit Institutions*, 33 O.J. EUR. COMM. (No. C 152) 6 (1990) (Commission Notice No. 90/c 152/06) [hereinafter *Capital Adequacy Directive*]. At the date of writing of this article, agreement had not been reached on the final form of an investment services directive. See *Plans to Break ISD Deadlock Fail But Solution May Lie With Markets*, FIN. REG. REPT. (July 1991).

<sup>101</sup> Securities Exchange Act Release No. 25,801, 41 SEC Docket 164 (June 14, 1988) [hereinafter *Rule 15a-6 Proposing Release*].

<sup>102</sup> Exchange Act, 15 U.S.C. §§ 78a-78kk (1988).

<sup>103</sup> Section 15(a)(1), 15 U.S.C. § 78o(a)(1) (1988), refers to the use of interstate commerce, and Section 3(a)(17) of the Exchange Act, 15 U.S.C. § 78c(a)(17) (1988), defines "interstate commerce" to include trade among the several states or between any foreign country and any state.

<sup>104</sup> Securities Act Release No. 4,708, 29 Fed. Reg. 9,828 (July 9, 1964), codified at 17 C.F.R. § 231 (1991) [hereinafter *Release 4708*]. Until the final adoption of Regulation S, Release 4708 was the cornerstone of the U.S. regime for extraterritorial application of the registration requirements under the Securities Act of 1933. In connection with its prescriptions for registration, it also covered the circumstances under which foreign underwriters could participate in a U.S. distribution, without being required to register as broker-dealers under U.S. law. Broadly, it provided that registration as a broker-dealer would not be required for (i) offshore sales to non-U.S. persons, or (ii) sales into the U.S. through a U.S.-registered broker-dealer.

<sup>105</sup> *Rule 15a-6 Proposing Release*, *supra* note 101, at 171 (citations omitted). We will take up later this explicit position that certain provisions of the U.S. securities laws are more extraterritorial than others.

vestors, outside the United States, the registration requirements would not apply. These positions are based on two rationales. First, the Commission views the purpose of the relevant provisions of the Exchange Act as principally to protect the integrity of the U.S. capital markets and to protect U.S. investors. Second, the Commission supports its views by appeals to comity and to the "legitimate expectations" of investors.<sup>106</sup>

The Commission rejects the argument that Section 30(b) of the Exchange Act,<sup>107</sup> which excludes from the application of the Exchange Act any person "insofar as he transacts a business in securities without the jurisdiction of the United States," would exempt foreign broker-dealers.<sup>108</sup> The Commission has interpreted this provision quite narrowly, arguing that "without the jurisdiction of the United States" does not mean outside U.S. territory, but means outside the prescriptive jurisdiction of the United States. Perhaps recognizing that this interpretation obviates the need for the provision, and is therefore difficult to accept as a matter of statutory construction, the Commission argues that even if activities outside U.S. territory are immune from the restrictions of the Exchange Act, solicitations by a foreign broker-dealer of sales into the United States would prevent the foreign broker-dealer from claiming that he was remaining outside the territory of the United States. However, this fall-back position is untenable, as it would appear to split up the foreign broker-dealer for regulatory purposes: subject to U.S. registration requirements with respect to its U.S. business, but exempt "insofar as" its business is outside the United States. While this is probably the logical effect of a strict reading of Section 30(b),<sup>109</sup> it is not an administrable outcome, perhaps indicating in part why Congress in the latter part of Section 30(b) called for the Commission to issue regulations applying the Exchange Act to certain persons *even if* they transact a business in securities outside the United States.<sup>110</sup> The Commission

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<sup>106</sup> See, e.g., *Rule 15a-6 Proposing Release*, *supra* note 101, at 172.

<sup>107</sup> 15 U.S.C. § 78dd(b) (1988).

<sup>108</sup> *Rule 15a-6 Proposing Release*, *supra* note 101, at 171 n. 39.

<sup>109</sup> For an analysis of § 30(b) and its legislative history, see Goldman & Magrino, *Some Foreign Aspects of Securities Regulation: Towards a Reevaluation of Section 30(b) of the Securities Exchange Act of 1934*, 55 VA. L. REV. 1015 (1969). See also *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 32 (D.C. Cir. 1987), in which Judge Bork accepts § 30(b) as evidence that Congress did not intend the Exchange Act to have application to purchases of securities by foreigners outside the United States.

<sup>110</sup> See Sachs, *supra* note 26. This article argues that the legislative history of the Exchange Act evinces an absence of Congressional intent to protect traders whose trades occur outside the U.S., and that therefore Congress did not, as many courts and commentators have assumed or found, fail to delineate the scope of extraterritorial application of § 10(b) and Rule 10b-5 under the Exchange Act. Under the logic of the recent *Boureslan* case, 111 S. Ct. 1227, the absence of a clearly expressed congressional intent to apply the law extraterritorially would preclude such application.

explicitly rejects this outcome, stating that it uses an "entity approach", which would subject an entire foreign firm to the registration requirements, even if only a small part of its business is effected within the United States.<sup>111</sup> Section 30(b) may be viewed as an instance of explicit Congressional delegation of discretion to apply U.S. law to foreign persons. The Commission has not exercised this discretion, perhaps because until recently it has found its regulatory goals better served by the widest scope of potential application of the Exchange Act, perhaps also because Section 30(b) does not distinguish, as the Commission does, between the extraterritorial application of the antifraud provisions of the Exchange Act and the extraterritorial application of the other provisions of the Exchange Act.

Rule 15a-6 as adopted implements the territorial principle in a limited way, by providing an exemption from the broker-dealer registration requirements of Section 15(a) for unsolicited securities transactions for U.S. investors, and for solicited transactions with certain types of institutional investors.

The exemption for unsolicited securities transactions is available where the foreign broker-dealer does not contact or solicit the U.S. investor. "Solicitation" is undefined, but may include, for example, the provision of research reports to investors.<sup>112</sup>

The exemption for transactions with institutional investors permits transactions through a U.S.-registered broker-dealer, responsible for compliance with U.S. securities laws. The Commission thought this conduit feature especially important in order to avoid a gap in the protection afforded by the net capital rule, as well as to be able to apply other U.S. regulation to the transaction and to ensure the availability of cooperation with Commission enforcement actions.<sup>113</sup> The U.S.-registered broker-dealer must participate in the solicitation, except for solicitations of institutional investors with over \$100 million in assets. In addition, the foreign broker-dealer must agree to provide the Commission with information and documents requested relating to transactions under this exemption. This last requirement may be explained as a means of maintaining regulatory effectiveness by maintaining the enforcement structure that exists with respect to registered broker-dealers, where foreign bro-

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<sup>111</sup> *Rule 15a-6 Release*, *supra* note 96, at 80,237. This approach may be compared to the "waiver by conduct" theory proposed in 1984 and apparently abandoned. Exchange Act Release No. 21,186 31 SEC Docket (CCH) 14 (July 30, 1984).

<sup>112</sup> Rule 15a-6(a)(2) and (3) permit research reports to be provided by foreign broker-dealers to institutional investors and for distribution by a registered U.S. broker-dealer, subject to certain conditions.

<sup>113</sup> See *Rule 15a-6 Release*, *supra* note 96, at 80,249.

ker-dealers are permitted to operate without registering. It might also be explained as an instance of the Commission requiring a concession of extraterritorial enforcement power to which it may not be entitled. This latter explanation is diminished in force by the fact that this requirement relates only to the permission for *direct* solicitation within the United States of institutional investors, rather than, for example, permission to effect unsolicited transactions for U.S. persons. The touchstone of the Commission's jurisdiction is territorial solicitation.

The problem with Rule 15a-6, and the Commission's general approach to international broker-dealer regulation, is that it asserts complete jurisdiction over a broker-dealer, even if only a portion of its transactions are solicited transactions with persons in the United States. This approach erects a barrier to transnational commerce, insofar as it does not accept that a single broker-dealer might wish to engage in business in multiple jurisdictions, and might find it uneconomic to comply with the regulatory requirements of each jurisdiction. For example, where the United States seeks to ensure the financial soundness of its brokerage systems through the net capital rule, which provides incentives for holding certain types of assets, another jurisdiction might impose a different rule that provides incentives for holding different types of assets. The inconsistent and overlapping requirements could make transnational business more costly than domestic business. An approach of mutual recognition could resolve this problem.

The Commission's "entity" approach exemplifies the principal difficulty in dividing up the world for purposes of prescriptive jurisdiction in connection with institutional regulation of financial services organizations: it is difficult to divide up a single multinational financial services organization for regulatory purposes. Therefore, each national regulator sees the need to regulate the entire multinational organization, or perhaps, as in the case of the scandal surrounding the Bank for Credit and Commerce International (BCCI), a multinational organization may escape effective regulation by any national regulator. This entity approach in Rule 15a-6 is the same in terms of prescriptive jurisdiction as the approach of Regulation K to foreign banking organizations that do business in the United States. Institutional regulation presents intractable problems in this regard, which can only be solved by either a process beginning with partial harmonization and expected to lead to more substantial harmonization, such as the Second Banking Directive, or a complete harmonization in critical areas, such as the Basle Accord discussed below.

The Broker-Dealer Concept Release is intended to explore the use of



the concept of mutual recognition, as a means to defer to foreign regulation of broker-dealers that also operate in the United States. The principle upon which it is based represents a departure from a generally regulatory-centric principle that U.S. regulation must apply to protect U.S. persons and markets, and that foreign regulation would not be an adequate substitute. It purports to represent an exploration of the regulatory principle of the Second Banking Directive and the proposed Investment Services Directive: essential harmonization and mutual recognition.<sup>114</sup> The Commission recognizes the regulatory problem of mutual recognition:

[T]he exclusion of foreign firms from U.S. regulatory requirements possibly could result in risks for U.S. investors and markets if the foreign regulatory system did not afford fundamental protections, or if the cross border activities of exempted broker-dealers were not adequately monitored by either U.S. or foreign regulatory authorities. The Commission believes, however, that a properly tailored approach recognizing foreign broker-dealer regulation can accomplish its goal of maintaining effective regulation of such cross border activities.<sup>115</sup>

The Commission proposal calls for the presence of all of the key safeguards of U.S. broker-dealer regulation. The elements of the concept, as described by the Commission, are as follows:

1. The foreign broker-dealer's business must be predominantly foreign. This component invites comparison to Regulation K's QFBO test, which has a similar requirement.<sup>116</sup> However, the test the Commission would apply would require that U.S.-related securities activities account for no more than 10% of securities revenues.<sup>117</sup> The Commission wishes to avoid providing incentives for U.S. broker-dealers to engage in regulatory arbitrage by relocating offshore.
2. The foreign broker-dealer must *not* have a U.S. broker-dealer affiliate, and must provide its services from outside the U.S. This latter prong may be illusory, or worse, difficult to satisfy, as the important issue is whether the foreign broker-dealer may make telephone calls to customers in the U.S. Compare this restriction to the right under the Second Banking Directive and the Investment Services Directive to either provide cross-border services, or to exercise the right of establishment by branching. The Commission is concerned that if it allowed a foreign broker-dealer operating within the U.S. to be exempted from U.S. regulation in deference to home country

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<sup>114</sup> This is not the first place where the U.S. has tried mutual recognition. For example, the Commodity Futures Trading Commission has established an exemption from its futures commission merchants rules for foreign merchants that only transact business in futures traded on a foreign board of trade, and who demonstrate that they are subject to a regulatory scheme comparable to that of the CFTC. See *Interpretive Statement with Respect to the Commission's Exemptive Authority Under § 30.10 of Its Rules*, 17 C.F.R. § 30, Appendix A.

<sup>115</sup> *Broker-Dealer Concept Release*, *supra* note 96, at 80,261.

<sup>116</sup> See text accompanying notes 57-68, *supra*.

<sup>117</sup> *Broker-Dealer Concept Release*, *supra* note 96, at 80,263.

regulation, the U.S. as a whole would be subject to competitive pressures to reduce its aggregate level of regulation: the so-called competition in regulatory laxity that is part of the deregulatory thrust of the Single European Act's approach to regulatory harmonization. It also supports this position by citing a different issue: the difficulty that the home country regulator would experience in regulating the foreign broker-dealer's U.S. operations, which regulation is critical to the Commission's willingness to defer thereto.<sup>118</sup> Finally, with respect to the first prong of this requirement, it expresses concern that if a foreign broker-dealer with an affiliate that is a U.S.-registered broker-dealer is permitted to operate in the U.S. without registration, the U.S.-registered broker dealer could evade certain U.S. regulatory requirements—principally the net capital rule—by booking business through its unregulated foreign parent.

3. It must limit its U.S. broker-dealer activities to transactions with institutional investors with over \$100 million in assets. This limitation significantly limits the operation of this concept to investors expected to have extremely high levels of sophistication, presumably those able to recognize, evaluate and accept the differences in regulation. With greater experience, the Commission would consider expanding the class of eligible investors.<sup>119</sup>

4. The existence of memoranda of understanding or treaties with the foreign broker-dealer's home country regulator, in order to support the Commission's reliance on the home country regulator as a substitute for its regulation. The Commission is careful not to abdicate its role as guardian of the U.S. public capital market, and thus wishes to ensure that its enforcement abilities will not be hindered by the fact that its targets are located abroad. It would require cooperation on both regulatory and enforcement matters.

5. The Commission must be satisfied that the home country regulatory regime is comparable to that of the U.S. This promises to involve difficult judgments, as well as an implicit recognition that there are aspects of our regulatory system that are not necessary to achieve the fundamental goals of broker-dealer regulation; this recognition may be difficult for the Commission to make. The Commission sets forth in its own image the key elements of broker-dealer regulation: qualification and conduct standards, financial responsibility standards, procedures for protection of customer funds and securities, credit regulation, a sound clearance and settlement system and a comprehensive monitoring and enforcement program.<sup>120</sup>

6. Continued applicability to the foreign broker-dealer of certain U.S. regulatory requirements. This might be occasioned by a gap, from a U.S. regulatory perspective, in the foreign broker-dealer's home country regulatory regime, in which case the Commission might fill the gap by applying a part of the U.S. regulatory regime that might not otherwise be applicable.

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<sup>118</sup> The Basle Committee's revised Concordat established principles for the allocation of bank regulatory responsibility between home state and host state including the principle of consolidated supervision. *Committee on Banking Regulations and Supervisory Practices: Revised Basle Concordat on Principles for the Supervision of Banks' Foreign Establishments*, 22 INT'L LEGAL MATERIALS 900 (1983).

<sup>119</sup> *Broker-Dealer Concept Release*, *supra* note 96, at 80,263.

<sup>120</sup> *Broker-Dealer Concept Release*, *supra* note 96, at 80,264.

7. This exemption would not depend on reciprocal acceptance of U.S. broker-dealer regulation by the foreign broker-dealer's home country.<sup>121</sup>

The pattern of restrictions that the Commission has seen fit to impose in order to liberalize access to U.S. markets for foreign broker-dealers, while seeking to maintain the integrity and coherence of its regulation, is evidence of the difficulty of accomplishing both goals simultaneously without high levels of international harmonization and cooperation. The Commission has been motivated by the goal of increasing the access of U.S. institutional investors to foreign markets, but has been reluctant to compromise any part of the spectrum of protections applicable to protect U.S. investors against self-dealing and other abuse by broker-dealers.

#### E. Comparison of Rule 15a-6 to Regulation K

Rule 15a-6 is a more limited approach to foreign financial institutions than the QFBO provisions of Regulation K, because it deals with foreign broker-dealers that by definition are not established in the United States. However, its approach is similar to that of Regulation K, insofar as it makes only limited regulatory concessions in order to reduce the extraterritorial application of the Exchange Act's registration requirement. Like Regulation K, it is based on a dual assumption that (i) the foreign regulatory system either cannot be evaluated or cannot be accepted as sufficient to protect U.S. regulatory interests, and (ii) it is costless to impose an additional layer of regulation on foreign financial institutions. The Broker-Dealer Concept Release would change the first assumption, calling for an evaluation of foreign regulatory systems. The next step would be to accept that it is not costless to impose an additional layer of regulation on foreign financial institutions, and on this basis to adopt a regime of mutual recognition based on essential harmonization. It is not costless for two reasons. First, it is a barrier to the free flow of capital and to trade in financial services that reduces overall efficiency. Second, other countries will view it not as a mere difference in regulatory taste, but as implicit protectionism, and will retaliate. These costs must be fully recognized and evaluated in the Commission's regulatory decision-making.

Rule 15a-6 is an instance of unilateral action to regulate transnational broker-dealers. Because it is unilateral, it must assume the worst about foreign regulatory regimes; it must protect against the worst foreign regulatory regimes, even when the foreign broker-dealer involved is

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<sup>121</sup> The Riegle-Garn Bill, *infra* note 127, if enacted, might change this approach, or form the basis for the Commission's decision to change this approach.

regulated by a strong foreign regulatory regime. Thus, it imposes costs inaccurately, for example, by requiring that foreign broker-dealers do business with U.S. institutional investors through U.S.-registered broker-dealers. This requirement adds to the costs involved in the transaction, because the U.S.-registered broker-dealer must be compensated to absorb the risks that this feature of the rule intends it to absorb. By adding to the costs of the transaction in this way, the Commission is imposing a regulatory barrier to effective competition by foreign broker-dealers. While the costs of this regulatory barrier may be justified in cases where the foreign broker-dealer is not subject to an adequate regulatory regime, the indiscriminate imposition of these costs in situations where the foreign broker-dealer may be subject to an adequate foreign regulatory regime cannot be so justified.

#### F. Comparison of Rule 15a-6 to the European Commission's Draft Investment Services Directive

The European Community recognizes that variations and overlaps of regulation diminish the efficiency of their internal market in capital and in financial services, and are moving forward internally on the basis of mutual recognition based on essential harmonization. The objectives of this process are to remove barriers to the free flow of capital and financial services, and to remove opportunities for hidden protectionism that raise possibilities for retaliation.

In 1990, the European Commission submitted to the Council of Ministers an amended proposal on investment services in the securities field.<sup>122</sup> The Investment Services Directive is currently under discussion in the Council. Its final agreement is subject to agreement on standards for capital adequacy for investment firms, under the proposed Capital Adequacy Directive discussed below.<sup>123</sup> It is also subject to agreement on whether off-exchange trading will be permitted, or whether alternatively, formal exchanges will have a monopoly on trading, and other issues.<sup>124</sup>

The Investment Services Directive is modelled on the Second Banking Directive, and would generally provide a similar single-license re-

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<sup>122</sup> *Investment Services Directive*, *supra* note 31. The investment services coming within the scope of the directive are brokerage of securities, money market instruments, financial futures and options and exchange rate and interest rate instruments, dealing of such instruments, underwriting of securities, market-making, portfolio management, investment advice and safekeeping of instruments.

<sup>123</sup> See text accompanying notes 125 - 126, *infra*.

<sup>124</sup> See Waters, *Securities Firms Look Across Borders*, *Fin. Times*, Jan. 7, 1991, at 4 (indicating that large banks are favored by off-exchange trading, which allows them to internalize trading, excluding smaller firms).

gime, with essential harmonization, home country regulation and host country mutual recognition, in the non-bank investment firm context. This is critical from the competitive standpoint of non-bank investment firms, which will compete with universal banks that are free to exercise a wide array of powers, and more importantly, that are free to operate throughout the European Community under the Second Banking Directive.

The pattern of regulation is similar to that under the Second Banking Directive, with essential harmonization of home state regulation in similar respects, allowing cross-border branching or provision of services one month after notification to the host state. The essential harmonization requires home states to mandate (i) sufficient *initial* capital under the Capital Adequacy Directive; (ii) suitable experienced managers and suitable shareholders holding stakes of 10% or more; (iii) sound administrative, accounting, record-keeping and internal control mechanisms; (iv) segregation of customers' cash and securities; (v) participation in a collective compensation scheme to protect customers in the event of the investment firm's bankruptcy (for branches, this will be effected under the compensation schemes in force in the *host* state, pending harmonization of these arrangements); (vi) quarterly financial reporting to home state authorities and (vii) organization in a manner that avoids harm to customers from conflicts of interest. This regulation is in the exclusive jurisdiction of the home state.<sup>125</sup> These rules do not define capital adequacy standards, which will also be the responsibility of the firm's home state and which will be covered in the separate Capital Adequacy Directive. Host states will not be permitted to require local endowment capital.<sup>126</sup>

As with the Second Banking Directive, the Investment Services Directive contains provisions on reciprocity with non-member states, as a basis for extending the market-opening benefits of the Investment Services Directive to firms based in non-member states. The reciprocity provisions contained in the Investment Services Directive are substantially identical to those contained in the Second Banking Directive. Obviously, the European Community decided to continue to use a formula that has proven acceptable to the outside world. This formula appears to be attractive to the United States as well.

Thus, the approach of the Investment Services Directive is more like the mutual recognition approach of the Broker-Dealer Concept Release than the limited exclusion approach of Rule 15a-6. The Investment Services Directive begins with multilaterally agreed essential harmonization

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<sup>125</sup> *Investment Services Directive*, *supra* note 31, at art. 11.

<sup>126</sup> *Investment Services Directive*, *supra* note 31, at art. 12(2).

in several areas that the Commission has stated are important for evaluating foreign home country regulation under the Broker-Dealer Concept Release.

### G. The Riegle-Garn Bill

The United States has under its federal law, since 1978, generally accorded national treatment to foreign banks operating here. This treatment has not been predicated on reciprocity by the home country of the foreign bank. In response to perceptions of increasing international competitive challenge to the United States in financial services, as well as to the reciprocity provisions of the Second Banking Directive, Senators Riegle and Garn introduced in January, 1990, a proposed bill entitled the Fair Trade in Financial Services Act of 1990.<sup>127</sup> The Bush Administration neither supports nor opposes the Riegle-Garn Bill, although the Board opposes it on the ground that it may precipitate retaliation against U.S. banks.<sup>128</sup> It would add a requirement of reciprocity by the foreign bank's home country as a requirement for certain aspects of national treatment under U.S. financial services regulation.<sup>129</sup> Like the similar requirements in the Second Banking Directive, this weapon is advertised as offensive, rather than defensive; that is, it is intended to be used as a crowbar to open foreign markets, such as Japan's, rather than to close U.S. markets to foreigners.<sup>130</sup> It is a response, in part, to perceptions of trade distortion resulting from regulatory subsidies to national competitors in other markets.

The Riegle-Garn Bill begins by requiring annual reports by the Secretary of the Treasury identifying those countries that do not accord national treatment to U.S. banks and describing the results of negotiations which the Secretary of the Treasury is required to initiate seeking na-

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<sup>127</sup> Fair Trade in Financial Services Act of 1990, S.2028, 101st Cong., 2d Sess., Cong. Rec. S. 476 (daily ed. Jan. 29, 1990). See also Senate Report No. 101-367 on S. 2028 as Reported by the Senate Committee on Banking, Housing and Urban Affairs. At the time this article was written, the latest version of the bill appeared as part of the proposed Defense Production Act Extension and Amendments of 1991, H.R. 991, 102nd Cong., 1st Sess. (March 11, 1991) [hereinafter the *Riegle-Garn Bill*]. The Riegle-Garn Bill would amend, *inter alia*, the International Banking Act of 1978, 12 U.S.C. § 3101 *et seq.* (1988) and the Exchange Act.

<sup>128</sup> *USTR Requests Changes in Financial Services Fair Trade Bill, Treasury Drops Opposition*, 8 INT'L TRADE REP. (BNA) 664 (May 1, 1991). The Bush administration had earlier threatened to veto the bill. Riddell, *Veto of US Banking Rules Retaliation Bill Threatened*, Fin. Times, Feb. 22, 1991, at 3.

<sup>129</sup> In this sense, it follows the Schumer Amendment under the Omnibus Trade and Competitiveness Act of 1988, 22 U.S.C. §§ 5341-5342 (1988), which requires that the Board determine whether U.S. firms are granted the same competitive opportunities as domestic firms in the home country of a firm seeking or holding primary dealer status for U.S. government securities.

<sup>130</sup> *Riegle-Garn Bill*, *supra* note 127, at § 202.

tional treatment. National treatment is defined as offering U.S. banks "the same competitive opportunities (including effective market access) as are available to its domestic banks and bank holding companies."<sup>131</sup> This standard appears comparable to the standard established in Article 9(4) of the Second Banking Directive, but does not provide the possibility that differing competitive opportunities from those afforded to host country nationals might still constitute effective market access, thereby not triggering sanctions.

The federal banking agencies are provided discretion, in consultation with the Secretary of the Treasury, to deny any application or disapprove any notice filed by a person of a foreign country<sup>132</sup> specified by the Secretary of the Treasury as failing to accord national treatment. These sanctions are intended to freeze the level of business activity, both functionally and geographically, of foreign banking organizations to the extent that existing U.S. regulations would require applications or notices to be submitted to any of the federal banking agencies. However, the federal banking agencies, in consultation with the Secretary of the Treasury, are required to consider U.S. international agreements governing financial services. In addition, they are mandated to consider with respect to foreign firms already operating in the United States the record of the foreign country in according national treatment to U.S. banks, and the nature of the sanctions that the foreign country would impose on U.S. banks for a failure of reciprocal national treatment by the United States. This requirement has been added to alleviate specific concerns that the sanctions available under the Riegle-Garn Bill were harsher than those available under the Second Banking Directive.<sup>133</sup> However, the European Community is still concerned that, unlike the Second Banking Directive, the Riegle-Garn Bill would provide the potential for attacks upon Community firms already doing business in the United States.<sup>134</sup>

The Riegle-Garn Bill would extend this reciprocal national treat-

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<sup>131</sup> *Id.*

<sup>132</sup> A person of a foreign country is any person organized under the foreign country's laws, any person that has its principal place of business in that country, any citizen or domiciliary of that country, or any person directly or indirectly controlled by any of the above. *Riegle-Garn Bill*, *supra* note 127, at § 202.

<sup>133</sup> See, e.g., Gruson, *Reciprocal National Treatment: Comparing EC Plan to Riegle-Garn Bill*, 9(7) BANKING EXPANSION REP. 2 (Apr. 2, 1990) (pointing out that the initial version of the Riegle-Garn Bill is harsher than the Second Banking Directive insofar as (i) the possibilities for retaliation under the Second Banking Directive are limited to denying new applications for entry, rather than halting the expansion of existing entrants, (ii) the Second Banking Directive has a three-month "sunset" provision, and (iii) the Second Banking Directive effectively "grandfathers" existing foreign banking organizations).

<sup>134</sup> *USTR Requests Changes in Financial Services Fair Trade Bill, Treasury Drops Opposition*, 8 INT'L TRADE REP. (BNA) 664 (May 1, 1991).

ment regime to foreign securities brokers and dealers, with some changes. The sanctions available, because broker-dealers generally do not need to apply or provide notices for new business, are simply denying foreign broker-dealers from offending countries the right to register as broker-dealers with the Commission, thereby excluding them from the U.S. market, or denying persons from such countries the right to acquire U.S. broker-dealers.<sup>135</sup>

The Riegle-Garn Bill represents a resurgence of protectionism—in access regulation—in a somewhat more productive form. It is a unilateral crowbar, providing restrictions on access in response to perceptions of foreign restrictions on access. In this sense, it is subject to the same criticisms that are levelled at unilateralism in trade generally: that it can degenerate into unprincipled retaliation and protectionism, diminishing aggregate welfare.<sup>136</sup> However, its suggestion is productive insofar as it recognizes that regulatory subsidies exist, that they cause trade distortions and that they diminish aggregate welfare. If these subsidies and protections cannot be reduced on a multilateral basis, which would be the optimal solution, it may make sense to seek their reduction unilaterally. In the next section, we consider a multilateral initiative that has been successful in helping to level the international banking playing field.

### III. FINANCIAL INSTITUTION CAPITAL: THE BASLE ACCORD

Capital regulation of financial institutions is intended to provide financial resiliency to financial institutions, and also to provide a margin of protection to customers. Requirements to maintain capital impose costs on financial institutions, which costs vary with the cost of capital to that financial institution. The amount of capital required of a financial institution should vary directly with the magnitude of the risks that it takes and imposes on others through deposit insurance or otherwise. The risks taken by a financial institution may be understood as a function of the

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<sup>135</sup> *Riegle-Garn Bill*, *supra* note 127, at § 403.

<sup>136</sup> In testimony on April 5, 1990, before the House Committee on Banking, Housing and Urban Affairs, Treasury Undersecretary Mulford described the administration's position on reciprocity:

The U.S. objection to even limited reciprocity has been the risk that reciprocity will be used and that retaliation would follow. The impact could be devastating to confidence in world financial markets and established patterns of monetary and capital flows. The President has clearly stated his opposition to measures that might restrict the flow of capital or increase protectionism—the marketplace should be free to allocate resources.

*National Treatment in Policy and Practice in the United States and Abroad, 1990: Hearing before the Subcomm. on Financial Institutions Supervisions, Regulation and Insurance and the International Competitiveness of U.S. Financial Institutions Task Force of the House Comm. on Banking, Finance, and Urban Affairs, 101st Cong., 2d Sess. 8 (1990) (Statement of David Mulford, Treasury Undersecretary). See also World Trade Survey, The Economist, Sept. 22-28, 1990, at 25-29, for a discussion of the advantages and disadvantages of the unilateral "crowbar" approach to international trade.*



type of business that it does, and the way that it does that business. These risks may be evaluated using the types of principles of risk assessment and underwriting applied by insurance companies in writing insurance policies: by reference to the category of risk and by reference to the loss experience of the particular insured.

The recent Treasury Report considers enhanced capital standards and supervision as almost a universal solvent for banking ills, as a means to insure against many of the risks in the system, or at least to make sure that the controlling interests of the financial institution—the equity holders—have a significant stake in its losses, as well as in its gains.<sup>137</sup> Thus, regulation of capital cannot be considered in isolation from regulation of institutional powers. On the other hand, capital represents a relatively tangible and measurable criterion for financial institution resiliency, and this quality, combined with its relatively unidimensional and universal character, as well as its significant contribution to financial institution costs, makes capital an attractive candidate for efforts at international regulatory cooperation.

The Basle Accord<sup>138</sup> has been hailed as one of the most important events in recent times in the field of coordination of bank regulation. It represents an informal but serious and binding (in the sense of moral and reciprocal obligation, rather than in the legally enforceable sense) agreement among the central bank governors of the Group of Ten<sup>139</sup> to harmonize capital adequacy requirements applicable to banks. It is different from Regulation K and from the main thrust of the Second Banking Directive, which deal largely with bank powers and supervision, insofar as it deals with a single financial and relatively discrete component of bank regulation. In fact, the Second Banking Directive is predicated

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<sup>137</sup> *Treasury Report*, *supra* note 19.

<sup>138</sup> BASLE SUPERVISORS COMMITTEE, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (July 1988) [hereinafter *Basle Accord*]. The Basle Accord is proposed to be supplemented and amended. See BASLE SUPERVISORS COMMITTEE, CONSULTATIVE PAPER ON INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS, 30 INT'L LEGAL MATERIALS 980 (1991). See generally Norton, *The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on "International Convergence of Capital Measurement and Capital Standards,"* 23 INT'L LAW. 245 (1989); Cooke, *International Convergence of Capital Adequacy Measurement and Standards*, in Festschrift for Jack Revell (Institute for European Finance, 1990); Hayward, *Prospects for International Cooperation by Bank Supervisors*, 24 INT'L LAW. 787 (1990).

<sup>139</sup> The Group of Ten is comprised of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland (which joined subsequent to the initial formation, making for 11 members) the U.K. and the U.S. The Group of Ten was formed in 1974 under the auspices of the IMF. The group operates through each country's finance minister, but also has ad hoc committees, such as the committee of central bank governors of the members, which meet at the Bank for International Settlements.

upon the agreement on bank capital standards represented by the Basle Accord, and established as law in the European Community under the Own Funds Directive and Solvency Ratio Directive.

One important question about the Basle Accord involves its subject matter: why was harmonization sought in capital adequacy, as opposed to other topics of bank regulation? Capital adequacy standards have emerged as a critical tool of bank regulation,<sup>140</sup> allowing regulators to effect two overlapping goals. First, as noted above, capital acts as a cushion of solvency, adding to the resiliency of banking institutions: the more capital a firm has (depending obviously on its cost of capital and its ability to service the cost of its capital), the more resilient it will be. In the event of bankruptcy, capital is normally entitled to returns only after debt, including deposits, has been fully paid. Second, capital acts as earnest money for bank shareholders: it is their risk capital and commands their diligence and prudence. The smaller the capital at stake in comparison to the total funds of the bank, the greater the risks the shareholders, who together exercise control over the bank (subject to bank regulation), may be willing to take. Prudential bank regulation is intended to further ameliorate the conflict of interest between shareholders and debtholders of banks, and of course, the government has a special concern as a contingent involuntary debtholder of all banks that benefit from government deposit insurance.

The Basle Accord was motivated by several factors. First, bank regulators were interested in enhancing banks' capital position, in order to enhance banks' ability to absorb losses due to LDC debt and other exposures. Second, they saw a need to forestall a possible competition in regulatory laxity in bank capital adequacy standards, whereby each country would promote the competitive position of its banks by reducing its capital adequacy requirements, especially at a time when the regulators were seeking capital increases.<sup>141</sup>

Far more difficult than establishing percentage requirements for capital is the process of determining what is capital and in respect of what assets capital is required.<sup>142</sup> The Basle Accord established optimis-

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<sup>140</sup> For a detailed dissection of the meaning and importance of capital requirements, see Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities*, 49 OHIO ST. L.J. 1299 (1989).

<sup>141</sup> Hayward, *supra* note 138, at 789.

<sup>142</sup> One question that arose in the context of the negotiation of the Basle Accord is whether certain hidden reserves held by Japanese banks comprised of the difference between the cost and the appreciated market value of equity securities should be counted as capital. Such reserves represent real value, but are subject to volatility, as demonstrated by the decline of the Japanese stock market in 1990. In the case of these hidden reserves, a compromise was struck, applying a "haircut" to the value of the reserves, with the intent that the haircut would represent a cushion against volatility. R.

tically-labelled "risk-based" capital requirements which seek, in a gross and limited fashion, to relate capital requirements to the relative riskiness or volatility of specific categories of assets. It also established requirements for specific levels of capital, including Tier 1 Capital and Tier 2 Capital (which includes certain types of capital that may be more volatile in value or may exhibit fewer of the characteristics of capital than Tier 1 Capital), as percentages of risk-weighted assets.<sup>143</sup>

Much of the difficulty in negotiation centered around the financial items that would be considered capital, and the way in which varying types of assets would be "weighted" in terms of risk. The national variations in position on what should be considered capital reflected variations in types of financial institutions, variations in financial practice and variations in regulatory approach. However, the variations in value and volatility of different assets were relatively easy to measure and compare, and therefore relatively easy to negotiate. They were relatively easy to measure and compare because financial assets are relatively fungible worldwide, due to recent increases in financial arbitrage and transfer of financial technology. In this context, where it is possible to be highly analytical and where there is greater uniformity of practice, possibilities for success in cooperation were greater than they would be with respect to powers regulation and transaction regulation, where it is more difficult to analyze the costs and benefits of regulation.

In the context of this single, but critical, parameter of institutional bank regulation, within the historical context of the late 1980s, including the impairment of money-center bank capital by the LDC debt crisis, relatively wide informal multilateral harmonization has been accomplished. It is further expected that countries outside the Group of Ten and the European Community will adopt the standards of the Basle Accord.<sup>144</sup>

The approach taken to capital in Rule 15a-6 stands in contrast to the multilateral approach of the Basle Accord. For broker-dealers that become subject to the U.S. registration requirements, the U.S. net capital rule would apply in full, with no mutual recognition of the foreign broker-dealer's home capital requirements. IOSCO has made significant recent progress toward harmonization of capital requirements for broker-

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VERNON, D. SPAR & G. TOBIN, *IRON TRIANGLES AND REVOLVING DOORS: CASES IN U.S. FOREIGN ECONOMIC POLICYMAKING* (1991).

<sup>143</sup> The European Community followed the Basle Accord pursuant to the Own Funds Directive, establishing the definition of capital, and the Solvency Ratio Directive, establishing a ratio of which capital is the numerator and risk-weighted assets is the denominator. These achievements were a prerequisite for the Second Banking Directive.

<sup>144</sup> See Hayward, *supra* note 138, at 792-93.

dealers.<sup>145</sup>

With extensive harmonization of capital requirements for banks pursuant to the Basle Accord, mutual recognition for compliance with this requirement is beside the point, except with respect to supervisory responsibility: mutual recognition would indicate that the home country regulator supervises compliance with the harmonized capital rules. With this exception, there is a tradeoff between harmonization and mutual recognition: one can replace the other. In addition, as demonstrated by the European Community, minimal or essential harmonization may be the precondition for mutual recognition. Further, it may be expected that a competition in reduction of regulatory cost spurred by mutual recognition would result in *de facto* harmonization.

Harmonization and mutual recognition are more difficult to the extent that the features sought to be harmonized or recognized vary in different societies, and are interwoven with other social and economic policies or institutions. Capital requirements appear relatively easy to disentangle and harmonize, but powers regulation or other institutional regulation may be more deeply embedded, and therefore more difficult to modify in connection with harmonization. As indicated above, one of the main problems with institutional regulation is that the institution often operates multinationally. How can the institution be cleaved in order to allocate prescriptive jurisdiction among appropriate countries in a way that will ensure neither overlap nor underlap of regulation? As we will see in the next section, transactional regulation may allow prescriptive jurisdiction to be allocated more efficiently, as transactional regulation relates to smaller units: the transactions, rather than institutions that may perform many transactions.

#### IV. TRANSACTION REGULATION: REGULATION S

Bank regulation generally focuses on institutions themselves, rather than on transactions,<sup>146</sup> while the central focus of securities regulation is transactional, and only secondarily focuses on the intermediary institutions. While, as described above, securities broker-dealers are subject to special regulation to ensure fidelity to customers' interests and to ensure adequate capital, this regulation is secondary to public offering and secondary market disclosure regulation, which is transactional in nature.

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<sup>145</sup> *Common Capital Standards Accord Emerging for Securities Industry*, Thomson's Int'l Banking Regulator, Oct. 4, 1991, at 1.

<sup>146</sup> Transaction regulation in banking is largely concerned with disclosure to consumers and other forms of consumer protection. As consumers need little protection with respect to deposits beyond federal deposit insurance, the focus of consumer protection is on consumers as borrowers.

This transactional disclosure regulation is at the core of the idea of a securities market, as it seeks to implement allocative efficiency by requiring that investors be provided with adequate information in order to make their investment decisions. In the United States, disclosure regulation consists of three main features: (i) requirements for disclosure of specific types of business and financial information; (ii) requirements for filing with the Commission, or registration, in order to allow the Commission to supervise disclosure; and (iii) antifraud provisions for civil and criminal liability, including private rights of action.

The registration requirements contained in Section 5 of the Securities Act<sup>147</sup> support the disclosure principle by requiring issuers of securities to register their offerings with the Commission. This allows the Commission to review or spot-check disclosure for compliance with disclosure requirements, and to compare disclosure of companies in the same industry. The registration requirements are ancillary to disclosure.

### A. Regulation S

Regulation S was intended to allow U.S. investors more easily to provide financing in foreign capital markets, and to facilitate foreign securities offerings by U.S. issuers. The process that led to the adoption of Regulation S was also motivated, in part, by concerns, at least among U.S. lawyers and investment bankers, regarding the erosion of the pre-eminent international position of U.S. capital markets due to the increasing competition of Tokyo and London.

On April 19, 1990, the Commission adopted Regulation S in order to clarify the extraterritorial application of the registration provisions of the Securities Act.<sup>148</sup> By doing so, the Commission filled at least a substantial part of a serious gap in the specificity of the Securities Act.<sup>149</sup> The gap in the delineation of the extraterritorial application of both the

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<sup>147</sup> 15 U.S.C. § 77(e) (1988).

<sup>148</sup> *Regulation S*, *supra* note 9. Regulation S was finally adopted in *Offshore Offers and Sales, Securities Act Release No. 6863* [1989-1990 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,524 (April 24, 1990) [hereinafter *Regulation S Release*]. This release, and the two prior releases, initially proposing Regulation S and modifying Regulation S prior to final adoption, are excellent sources of background. See *Offshore Offers and Sales, Securities Act Release No. 6838* [1989-1990 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,426 (July 11, 1989) (modifying original proposal) [hereinafter *Regulation S Reproposing Release*] and *Offshore Offers and Sales, Securities Act Release No. 6779* [1987-1988 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,242 (June 10, 1988) (initial proposal) [hereinafter *Regulation S Initial Release*]. See also Bloomenthal, *The SEC and Internationalization of Capital Markets: Herein of Regulation S and Rule 144A - Part II*, 19 DEN. J. INT'L L. & POL'Y 343 (1991).

<sup>149</sup> The gap had been filled before by Release 4708, *supra* note 104, and by no-action letters and market practice based thereon.

registration provisions and the antifraud provision had been filled with respect to the registration provisions by Release 4708 and practice thereunder, but with less clarity and economy.

Regulation S does not clarify the extent of the extraterritorial application of the antifraud provisions, with the idea that it is inappropriate to provide a "roadmap to fraud" and appropriate to provide some *in terrorem* effect against potential fraud.<sup>150</sup> This is probably an appropriate perspective for an earnest and vigorous regulator; however, the problem with this proviso is that the securities laws provide significant private rights of action, as well as Commission antifraud enforcement powers, pursuant to which an issuer that properly avoids the registration requirements under Regulation S might be held accountable for failing to meet rigorous U.S. disclosure standards that exceed the disclosure standards under which the issuer thought it was working.<sup>151</sup> Nor does Regulation S clarify the extent of the extraterritorial application of state securities laws, the "Blue Sky" laws.

Under the Commission's analysis, however, similar statutory language is interpreted to provide different bases for and ambits of extraterritorial prescriptive jurisdiction. This variation raises questions of consistency in our relations with other countries, as well as statutory authorization. The Restatement (Third) of the Foreign Relations Law of the United States<sup>152</sup> supports this variation, arguing that under its interest-balancing test, the character of the activity to be regulated affects the reasonableness of the exercise of prescriptive jurisdiction: "[t]hus, an interest in punishing fraudulent or manipulative conduct is entitled to greater weight than are routine administrative requirements." This argument is acceptable insofar as reasonableness is the touchstone of prescriptive jurisdiction, as it is under the Restatement Third, because the reasonableness test provides varying weights to different policy interests. However, this inconsistency of interpretation of identical statutory expressions of prescriptive jurisdiction indicates a problem with the reasonableness analysis from the U.S. domestic perspective: its lack of statutory support. There is also a substantive problem: the reasonable-

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<sup>150</sup> *Regulation S Release*, *supra* note 148, at 11, 16-17. The Commission cites language in *Bersch v. Drexel Firestone Inc.*, 519 F.2d 974, 986 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975): "It is elementary that the antifraud provisions of the federal securities laws apply to many transactions which are neither within the registration requirements nor on organized American markets."

<sup>151</sup> *But see MCG, Inc. v. Great Western Energy Corp.*, 896 F.2d 170 (5th Cir. 1990) (holding that the U.S. antifraud rules would not protect a U.S. investor in a foreign offering, where the U.S. investor evaded the safeguards established by the issuer to avoid offering and selling securities to U.S. persons).

<sup>152</sup> RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 416 comment (a) (1987).

ness analysis can result in varying scopes of prescriptive jurisdiction, depending on the level of interest a particular country has in the conduct in question. This assumes that the foreign country or countries do not have a countervailing interest. In this connection, consider the U.S. securities laws' critical goal of deterring fraud in connection with securities transactions. Even if the relevant foreign country has a similar goal of deterring fraud, it may have a different definition of fraud. The prescriptive jurisdiction problem arises because the foreign country does not consider the conduct in question to constitute fraud.<sup>153</sup> Thus the foreign country may have a countervailing regulatory goal: to avoid having its securities markets become subject to the additional costs of compliance with U.S. disclosure standards. In the face of this countervailing interest, it is not clear why the antifraud provisions should be given broader application than the registration provisions.

Section 5 of the Securities Act requires all non-exempt offers and sales of securities using the jurisdictional means of interstate commerce to be registered with the Commission. The interpretive issue for which Regulation S provides a response is: what is meant by "interstate commerce?"<sup>154</sup> More specifically, the question might be phrased by the Commission as what is meant by "interstate commerce" in the context of the registration provisions of the Securities Act, as we have seen that the Commission takes the view that different provisions of the securities laws and of other U.S. financial regulation have different scopes of prescriptive jurisdiction. Regulation S codifies and elaborates practice under Release 4708 and numerous "no-action" letters interpreting and expanding Release 4708. These emanations from the Commission attempt to fill the statutory gap in the Securities Act. They have done so with the goals of the Commission under the Securities Act in mind: careful and comprehensive disclosure regulation of public offerings to U.S. persons or in the United States. The Commission has also considered "comity" an important factor in determining the scope of application abroad of the registration requirements:

Principles of comity and the reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States to define requirements for transactions effected offshore.<sup>155</sup>

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<sup>153</sup> There may be other less substantive reasons, such as that the counterpart country provides a lesser standard of recovery, or less effective procedures.

<sup>154</sup> Section 2(7) of the Securities Act, 15 U.S.C. § 77b(7) (1988), defines "interstate commerce" to include "trade or commerce in securities or any transportation or communication relating thereto . . . between any foreign country and any State, Territory or the District of Columbia. . . ."

<sup>155</sup> *Regulation S Release*, *supra* note 148, at 15 (citations omitted).

This is an argument for mutual recognition. This approach to mutual recognition differs from that imposed under European Community law pursuant to the single market program and specifically under the Second Banking Directive, insofar as it is based on "soft" law: a discretionary approach to comity and expectations of market participants. In this sense it is not mandatory for the United States to provide this type of mutual recognition. However, the Commission, here and in connection with Rule 15a-6, appears willing to provide limited mutual recognition.

The Commission has recently proposed expanding the concept of mutual recognition significantly, in connection with tender offers, exchange offers and rights issues.<sup>156</sup> With respect to tender offers and exchange offers, these proposals would recognize that it is inappropriate to apply the full U.S. rules to offers with respect to which only a small minority of shareholders are U.S. persons. This proposal differs from Regulation S, which would call for the full application of U.S. registration requirements in connection with a public offering where only a small minority of purchasers are U.S. persons.

Regulation S is based on a territorial approach to the application of the registration requirements: if the offering takes place "in" the United States, it must be registered. If it does not, it need not. The Commission will not apply registration requirements to protect U.S. citizens purchasing securities abroad; such protection is unnecessary to carry out the Commission's principal purpose.<sup>157</sup> The touchstone for prescriptive jurisdiction here is where the transaction takes place, more than who the purchaser is, although who the purchaser is may affect the complex determination of where the transaction takes place. In accepting this principle, the Commission accepts the idea that investors who are U.S. citizens, by acquiring securities outside the United States, may effectively choose to forego the protections of the registration requirements and U.S. disclosure requirements. "As investors choose their markets, they choose the laws and regulations applicable in such markets."<sup>158</sup> This concept, though undoubtedly accurate at one level, may be inconsistent with Section 14 of the Securities Act,<sup>159</sup> which provides that contractual waivers of compliance with the Securities Act are void. However, in

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<sup>156</sup> International Tender and Exchange Offers, Securities Act Release No. 6897, 48 SEC Docket (CCH) 1646 (June 5, 1991); Cross-Border Rights Offers, Securities Act Release No. 6896, 48 SEC Docket (CCH) 1617 (June 5, 1991). For a summary of these proposals and their context, see Bartos, *A New Deal for US Investors in Foreign Markets*, INT'L FIN. L.R., July 1991, at 27.

<sup>157</sup> We will see below that this distinguishes the Commission, and the securities laws, from the Internal Revenue Service, and the tax laws.

<sup>158</sup> *Regulation S Release*, *supra* note 148, at 15-16.

<sup>159</sup> 15 U.S.C. § 77n (1988).



*Scherck v. Alberto-Culver*,<sup>160</sup> the Supreme Court held that this policy against waivers (in the context of a similar provision in the Exchange Act) might give way in the international context to the goal of fostering certainty in international commerce.

This territorial approach is implemented through a general statement to the effect that offers and sales that take place outside the United States are not required to be registered under Section 5 of the Securities Act,<sup>161</sup> and two safe harbors<sup>162</sup> to provide mechanisms for issuers to achieve relative certainty that their offerings are, indeed, outside the United States. The work that has gone into elaborating this simple standard shows that merely stating that the principle to follow in resolving prescriptive jurisdiction problems is territoriality does not definitively resolve these problems. This is because territoriality includes several concepts, including degree of territorial conduct, degree of territorial effects and a comparison to territorial conduct and effects elsewhere.<sup>163</sup>

Regulation S begins with a series of preliminary notes, the second of which expresses the Commission's ambivalence about the delimitation of regulatory jurisdiction represented by Regulation S:

In view of the objective of these rules and the policies underlying the Act, Regulation S is not available with respect to any transaction or series of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act. In such cases, registration under the Act is required.<sup>164</sup>

While the Commission would no doubt protest that this type of provision, like its analogs in the U.S. tax laws,<sup>165</sup> would not be used much and is necessary to prevent abuse, a practitioner might respond that this type of broad regulatory safety valve poses unacceptable risks to the issuers that obviously will plan to *avoid* (but not *evade*?) the registration requirements. Like the separation of the registration requirements from the antifraud requirements, this ambivalence is based on regulo-centrism

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<sup>160</sup> 417 U.S. 506, 517 (1974).

<sup>161</sup> *Regulation S*, *supra* note 9, at Rule 901.

<sup>162</sup> *Regulation S*, *supra* note 9, at Rules 903 and 904. These are non-exclusive safe harbors: compliance with one of the safe harbors allows the issuer not to register, but non-compliance does not necessarily result in a registration obligation, so long as the requirements of the general statement are met.

<sup>163</sup> See, e.g., RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 402(1) (1987), elaborating at least three approaches to territoriality, and § 403(2)(a) and (b), describing a relativist approach to territoriality.

<sup>164</sup> *Regulation S*, *supra* note 9, at preliminary note 2.

<sup>165</sup> See, e.g., Treas. Reg. § 1.861-7(c) (1991), changing the "passage of title" rule for determining the source of income from sales of inventory, by stating that where "tax avoidance" is involved, all factors of the transaction will be considered. In the tax case, the ambivalence is between providing clear rules and trying to avoid providing means for tax avoidance or evasion.

and an unwillingness definitively to give up the possibility of applying U.S. regulatory principles to foreign activity.

Section 901, the general statement, has been reduced significantly from the general statement included in the Regulation S Initial Release and the Regulation S Reproposing Release, which contained much more substantive guidance, including a list of factors to be considered in determining whether an offering is offshore. The general statement as finally promulgated merely provides that Section 5 of the Securities Act does not apply to offers and sales of securities that occur outside the United States. Section 902 provides a series of definitions, and Sections 903 and 904 provide safe harbors under which an offering is deemed to occur outside the United States.

Section 903 is the safe harbor applicable to sales by issuers of securities. It significantly liberalizes prior practice in the offshore offering area, allowing less restricted offerings. It requires first, that the offer and sale be made in an "offshore transaction;" second, that no "directed selling efforts" be made in the United States by the issuer or any underwriter or other distributor; and third, that depending on the perceived risk that securities offered will flow back to the United States, certain safeguards be established to cause them to "come to rest" abroad. An "offshore transaction" is one where the offer to sell is made offshore. In addition, for purposes of this safe harbor, either the seller must believe the buyer to be outside the United States, or the transaction must take place through an established foreign securities exchange.<sup>166</sup> "Directed selling efforts" means any activity that could reasonably be expected to stimulate U.S. interest in the securities.<sup>167</sup> The safeguards required to be established in order to ensure that the securities come to rest abroad depend on the type of issuer and the type of security involved. No additional safeguards are required in the case of securities issued by a foreign issuer for which there is no substantial U.S. market interest, as defined.<sup>168</sup> In addition, no additional safeguards are required for securities sold in an "overseas directed offering," which is an offering by a foreign issuer in a single foreign country, or an offering by a U.S. issuer in a single foreign country of debt securities denominated in a foreign currency.<sup>169</sup> For securities of issuers required to file annual, quarterly and interim reports under the Exchange Act, and for debt securities of other issuers, certain offering restrictions are required, including appropriate legends on the offering

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<sup>166</sup> *Regulation S*, *supra* note 9, at § 902(i).

<sup>167</sup> *Regulation S*, *supra* note 9, at § 902(b).

<sup>168</sup> *Regulation S*, *supra* note 9, at § 902(n).

<sup>169</sup> *Regulation S*, *supra* note 9, at § 902(j).

documents, and forty-day lock-ups during which the securities may not be sold to U.S. persons. For other offerings, similar offering restrictions are required, as well as a forty-day lock-up for debt securities and a one-year lock-up for equity securities, as well as buyer certifications to the effect that they are not U.S. persons and other safeguards.<sup>170</sup> U.S. personhood is determined based on residency, rather than citizenship.

Section 904 is the resale transactions safe harbor for transactions by persons other than the issuer or distributors on behalf of the issuer. It includes the same requirement for an offshore transaction, and the same prohibition on directed selling efforts in the United States, as Section 903. However, it modifies the safeguards required in order to ensure that the securities come to rest abroad, imposing on dealers in securities during the lock-up periods applicable under Section 903 the obligation not to sell to anyone known to be a U.S. person, and only to sell to other dealers with a notice stating that the securities are subject to the lock-up.

Regulation S has been hailed as an advance in the certainty, economy and logic of the U.S. regulatory approach to foreign securities offerings. It is indeed a useful exercise in administrative determination of the extraterritorial scope of the U.S. securities laws. One significant question about this exercise is what statutory basis the Commission has for delimiting the reach of Section 5 of the Securities Act. In a sense, this question is not a new one, as it is at least as old as Release 4708. As noted above, the Commission has made some policy choices in promulgating Regulation S, determining that it only applies to certain parts of the securities laws, and determining the circumstances under which it is available.

The Commission refers to Section 19<sup>171</sup> of the Securities Act as authority for Regulation S. Section 19 gives the Commission authority to make such rules as are necessary to carry out the provisions of the Securities Act. Regulation S can be evaluated against this authority in two ways. First, it might be argued that Section 19 provides authority for Regulation S because there are implicit in Section 5 and in the definition of interstate commerce limits on the prescriptive jurisdiction meant to be exercised by Congress.<sup>172</sup> For example, the definition of interstate commerce, which tracks the Commerce Clause of the Constitution, speaks of commerce *among* the several states and *with* foreign nations, implying that Congress did not intend to reach commerce that does not involve

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<sup>170</sup> *Regulation S*, *supra* note 9, at § 903(c).

<sup>171</sup> 15 U.S.C. § 77s (1988).

<sup>172</sup> See § 2(a)(7) of the Securities Act, 15 U.S.C. § 77b(7). The Commerce Clause of the Constitution has similar language. U.S. CONST. ART. 1, § 8, cl. 3. For an analysis of the constitutional arguments, see Brilmayer, *The Extraterritorial Application of American Law: A Methodological and Constitutional Appraisal*, 50 LAW & CONTEMP. PROBS. 11 (1987).

the United States. The question left unanswered by this proposition is what does it mean to involve the United States in this world of interdependence, arbitrage and fungibility? A plausible argument can be made that all financial transactions, whether denominated in dollars or not, affect the U.S. economy, at least indirectly.<sup>173</sup> However, this argument is unacceptable in the international arena, and thus it is for Congress or the Commission, or the courts, to further define the magnitude of involvement that will be sufficient to invoke the application of U.S. laws. On this basis, the Commission may argue that it is necessary for it to make rules delimiting the jurisdictional reach of Section 5. Second, it might be argued that it is necessary to delimit the ambit of the registration requirements, because it is physically and politically impossible to apply them to the full range of conduct that the definition of interstate commerce reaches.<sup>174</sup>

#### B. Regulation S and the TEFRA D Rules: An Example of U.S. Regulatory Disharmony

As described above, Regulation S was intended to clarify, and to liberalize, the extent of U.S. securities regulation of offshore offerings. However, the liberalization actually achieved was less than expected, because the IRS could not accept the complete liberalization that the Commission was seeking. The IRS, and the tax laws, have different goals and methods than the Commission and the securities laws. For example, U.S. citizens are subject to U.S. taxation on their worldwide income (subject to limited tax credits for certain foreign income taxes), regardless of the fact that they may be resident abroad, whereas one theme of Regulation S is to protect U.S. markets, rather than necessarily investors who are U.S. citizens. In particular respects, these goals and methods coincided for a time to make compliance with certain securities law requirements suffice to satisfy certain tax law requirements. As the Commission liberalized in accordance with its regulatory goals, it changed its rules in a way that ended this coincidence of method. In order to understand this

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<sup>173</sup> This would be similar to the cumulative effects test applied in domestic interstate commerce analysis under *Wickard v. Filburn*, 317 U.S. 111 (1942).

<sup>174</sup> The Commission's authority to make rules is limited by the requirement that the Commission act in a manner that is neither arbitrary nor capricious, and by the requirement that its rulemaking not be in excess of statutory authority. It is appropriate to consider the question of whether, in light of the statutory context, it is arbitrary for the Commission by regulation (as opposed to the exercise of prosecutorial discretion) to divide the world for purposes of the prescriptive jurisdiction of the registration requirements on territorial lines, but to continue to purport to apply the antifraud provisions of the securities laws more broadly.

issue, it is necessary briefly to review the history of U.S. tax treatment of eurobond offerings by U.S. issuers.

The U.S. Tax Reform Act of 1984 created a "portfolio interest" exemption from the U.S. 30% withholding tax applicable on interest paid to foreign creditors. This allowed a significant simplification of procedures for offerings by U.S. issuers in the eurobond market.<sup>175</sup> Under interpretive regulations subsequently issued by the IRS in accordance with the bearer bond provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), this portfolio interest exemption was available for eurobonds in bearer form (as opposed to those that are in registered form, meaning that they can only be transferred by a notation on the books of a registrar or transfer agent). However, for bearer bonds, certain safeguards are required. The IRS views the safeguards as necessary in connection with offerings by U.S. issuers in order to prevent bearer bonds from being purchased by U.S. investors as a means of evading their U.S. tax obligations. Bearer bonds are particularly susceptible to use to evade taxes, because they may be held anonymously, and the owner may receive payments of interest and principal without revealing his or her identity. While this concern may indeed be valid, the restrictions placed on offerings by U.S. issuers must be insufficient to accomplish its purpose, as the greater integration of capital markets and fungibility of debt obligations issued by U.S. issuers with those issued by foreign issuers means that investors should be relatively indifferent between U.S. bearer bonds and foreign bearer bonds.

The safeguards imposed by TEFRA on bearer bonds of U.S. issuers were a foreign issuance requirement and a foreign payment of interest requirement: seeking to ensure that the securities were offered and sold to non-U.S. persons, and that interest is payable only outside the United States.<sup>176</sup> Issuers that do not comply with these requirements would be denied deductions for interest payments on these bonds, and would be subject to an excise tax. In addition, U.S. holders would be subject to certain sanctions under U.S. tax laws, including denial of capital gains

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<sup>175</sup> For the background of these provisions, see Pergam, *Legal Dimensions of Eurobond Financing*, 1989 SMU INSTITUTE OF INTERNATIONAL FINANCE (1989).

<sup>176</sup> IRC § 163(f)(2)(B) requires bearer bonds to comply with the following requirements in order to avoid certain tax penalties, including denial of deductibility of interest for the issuer:

- (i) there are arrangements reasonably designed to ensure that such obligation [an obligation in bearer form] will be sold (or resold in connection with the original issue) only to a person who is not a United States person, and
- (ii) in the case of an obligation not in registered form—
  - (I) interest on such obligation is payable only outside the United States and its possessions, and
  - (II) on the face of such obligation there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws.

treatment and denial of loss deductions. The regulations issued under the Tax Reform Act of 1984 elaborated the foreign issuance requirement and foreign payment of interest requirement.<sup>177</sup>

Under the 1984 regulations, the foreign issuance requirement is met if the bonds are offered, sold and delivered outside the United States and either (i) the issuer receives an opinion of counsel that the obligation is exempt from registration under the Securities Act because it is intended for distribution only to non-U.S. persons, or (ii) the offering meets a four-part test. The four-part test involves agreements by the distributors of the offering that they will not offer or sell to U.S. persons (except financial institutions under certain circumstances), requirements that the distributors send confirmations to purchasers requiring the purchasers to represent that they are not U.S. persons, requirements that the purchasers certify that they are not U.S. persons in order to receive delivery of definitive bonds, and requirements that the issuer and distributors not have knowledge of the falsity of such certificate. The foreign payment of interest requirement is met if interest is payable only on presentation of an interest coupon outside the United States, and not by transfer to a U.S. account or by mail to a U.S. address.

Regulation S could have made the first alternative means of satisfying the foreign issuance requirement easier to meet, insofar as the first alternative relies on the securities law test. However, the IRS was not satisfied with Regulation S as a means of satisfying the foreign issuance requirement, for two reasons. First, Regulation S, in a departure from previous securities law practice, uses a residence-based definition of U.S. person, while U.S. tax law concerns mandate a definition that covers either citizenship *or* residency.<sup>178</sup> Second, and perhaps more importantly, Regulation S eliminates the need for purchaser certification of non-U.S. personality for offerings of bearer bonds of U.S. issuers required to file annual, quarterly and interim reports under the Exchange Act. The restrictions imposed on these offerings by Regulation S, as stated above, include certain offering restrictions, including appropriate legends on the offering documents, as well as forty-day restricted periods during which debt securities may not be sold to U.S. persons (based on residency), but not including certifications as to non-U.S. personality of the

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<sup>177</sup> T.D. 7965, 49 Fed. Reg. 33228 (1984); T.D. 7966, 49 Fed. Reg. 33236 (1984); T.D. 7967, 49 Fed. Reg. 33239 (Aug. 22, 1984). Amended versions of these regulations have appeared as IRS Regs. §§ 1.163-5(c)(2)(i)(A) and (B), which have been replaced by the TEFRA D rules described below, and as Reg. § 1.163-5(c)(2)(i)(C), which will continue to be available under certain circumstances for foreign issuers and foreign branches of U.S. banks.

<sup>178</sup> IRC § 7701(30).

purchaser. Therefore, the IRS adopted independent requirements for satisfaction of the foreign issuance requirement.

The IRS requirements—known as the TEFRA D rules<sup>179</sup>—were issued on May 4, 1990, two weeks after Regulation S was promulgated, and in response to Regulation S. The principal features that distinguish TEFRA D from prior tax regulation requirements and from Regulation S with respect to offerings of bearer bonds—the instrument of choice in the eurobond market—are as follows.

First, TEFRA D requires generally that no offers or sales in the United States *or* to U.S. persons be made by the issuer or any distributor during a forty-day restricted period, and that the bonds be delivered outside the United States. The definition of “U.S. person” is based on citizenship *or* residency. Thus, while Regulation S would permit an offering of eurobonds to be made in a way that would not discriminate between foreign persons and U.S. persons resident abroad, TEFRA D would require such discrimination. A distributor—generally, any person who offers or sells the securities during the 40-day restricted period under a contract with the issuer or with a person under a contract with the issuer—is deemed to comply with this restriction if it covenants to do so, and has in place procedures reasonably designed to let its employees or agents know of the restrictions.

Second, TEFRA D requires that the issuer obtain a certificate of the owner of the bond or of a financial institution through which the owner owns the bond, certifying that the obligation is not owned by a U.S. person, or is owned by an eligible U.S. person or financial institution. Regulation S requires certificates in connection with offerings of debt securities only for U.S. issuers that are not subject to the reporting requirements of the Exchange Act. TEFRA D contains an exception to the certification requirement for offerings targeted to countries where certification is expected to be impermissible under local law, subject to the satisfaction of a number of requirements designed to indicate that the offering is targeted to purchasers in that country. It is expected that certification will be impermissible under the laws of Germany and Switzerland.

The TEFRA D provisions have clear statutory backing for their restriction of offerings to U.S. persons defined by reference to either citizenship *or* residence. In addition, this approach is consonant with the jurisdictional approach of U.S. tax law: to tax all citizens *and* residents.

The statutory basis for the TEFRA D requirement of certification where Regulation S would not require certification is less clear. The IRS

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<sup>179</sup> TEFRA D Rules, *supra* note 10.

imposed this requirement despite liberalization by the Commission in Regulation S in a context where their immediate goals are similar: to require that the offering is reasonably designed (using the language of the tax law) to ensure that the bonds will not be sold to U.S. persons. However, the underlying rationale of the securities law rule is to maintain the protections afforded by the registration requirements (here meaning the requirement to file a registration statement with the Commission) of the securities law. The underlying rationale of the tax law rule is to avoid the possibility that U.S. persons (as defined under the tax law) would use bearer bonds to evade U.S. taxes. While the Commission is willing to allow U.S. citizens effectively to waive the protections of the registration requirements (but not necessarily the protections of the antifraud provisions), it would obviously be inappropriate for the IRS to allow U.S. persons to waive the protections against bearer bonds being used to facilitate tax evasion. However, the TEFRA D rules significantly diminish the benefit of Regulation S in the context of eurobond offerings, which generally require bearer securities.

C. Comparison of the Approach of Regulation S to that of the  
Reciprocal Prospectus Initiative and the European  
Community Common Prospectus Initiative

In most markets, securities offering regulation is based on disclosure. Multinational offerings of securities have in recent years become common, and are recognized as an effective way to broaden the marketing of securities, also adding stability and depth to the secondary market for an issuer's securities. However, most countries regulate public offerings, and each country's regulation differs, requiring varying levels and types of disclosure, and requiring varying types of government review processes. These variations can impede public offerings in two ways: first, by requiring varying disclosure documents to be prepared satisfying the requirements of each jurisdiction in which securities are to be offered, and second, by requiring varying schedules for offerings in different jurisdictions. These variations can thus be costly, and can raise unnecessary uncertainty in particular transactions. Regulation S merely describes certain circumstances under which an offering will be deemed not to take place in the United States, and therefore will not be required to comply with the U.S. disclosure and timing requirements. It does not address the problem of how to proceed when a public offering is intended to take place in the United States as well as in one or more other jurisdictions. The unilateral U.S. initiatives and the European Community initiatives discussed below seek to address this problem.



### 1. *Reciprocal Prospectus Initiative*

In 1985, the Commission proposed two methods for facilitating multinational offerings of securities in the United States, Canada and the United Kingdom.<sup>180</sup> The two methods proposed for comment were: (i) a reciprocal approach whereby a prospectus accepted in the domicile of the issuer of securities would be accepted in the other countries, and (ii) a common prospectus approach, which would entail complete harmonization of prospectus requirements, at least for multinational offerings. The reciprocal approach, like the single banking license of the Second Banking Directive, calls for a degree of satisfaction with the other country's requirements—and therefore usually a degree of “essential” harmonization—but not for complete harmonization.

The 1985 Multinational Offerings Release summarized some of the differences in disclosure practices among the United States, Canada and the United Kingdom. It indicated that there are substantial differences, based on legal requirements and market practice. The U.S. requirements are more detailed, and require certain different information. For example, U.S. law requires that the issuer depict its business broken down into its geographic and product business segments. Foreign issuers find this unattractive, as it requires additional accounting expense and may provide useful information to competitors. In addition, variations in accounting practice result in different definitions and treatment of certain accounting items, rendering financial statements prepared under different accounting systems non-comparable. Finally, and perhaps most important, the Multinational Offerings Release describes the difference in liability for omissions and misstatements in connection with offerings. The main difference here is in the legal system and legal culture, with far fewer private lawsuits for securities fraud in Canada and the United Kingdom than in the United States. These differences in disclosure standards and liability would have to be addressed in order to implement a common prospectus approach.

This past June, the Commission adopted a proposal for a reciprocal prospectus approach with Canada.<sup>181</sup> It hopes to extend the approach to other jurisdictions in the future.

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<sup>180</sup> Facilitation of Multinational Securities Offerings, Securities Act Release No. 33-6568, 32 SEC Docket (CCH) 707 (February 28, 1985) [hereinafter *Multinational Offerings Release*].

<sup>181</sup> Multijurisdictional Disclosure and Modification to the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 6902, 49 SEC Docket (CCH) 260 (June 21, 1991) [hereinafter *MDS Release*], amending Release No. 6879, 47 SEC Docket (CCH) 526 (October 16, 1990), which amended Release No. 6841, 44 SEC Docket (CCH) 56 (July 24, 1989). Canada was chosen as the first partner because of the greater similarity between the U.S. and Canadian disclosure and liability standards. In addition, as discussed below, the U.K. is involved with another, more

The Commission refers to this approach as a hybrid between mutual recognition and harmonization.<sup>182</sup> It is a hybrid in the sense that it involves a certain degree of harmonization of requirements, and a general but incomplete effort toward mutual recognition. Mutual recognition is qualified by a number of U.S. requirements that are imposed in addition to the requirement for satisfaction of Canadian requirements. First, financial statements of the issuer are generally required to be reconciled to U.S. generally accepted accounting principles for at least the first two years, meaning that certain items must be re-calculated in accordance with U.S. principles. Auditors of the issuer's financial statements for at least the most recent year would be required to comply with U.S. standards of independence.

It is noteworthy that this approach covers only registration requirements and requirements regarding categories of information to be disclosed, not the application of antifraud provisions; Canadian issuers may generally make their disclosure in accordance with Canadian law, but will not be exempted from the rigorous U.S. antifraud rules. This dichotomy between registration and information requirements on the one hand, and antifraud provisions on the other, is consistent with the approach taken in Regulation S, but it raises greater questions in the reciprocal prospectus context. The dichotomy does not raise the problem that an issuer would be subject to liability for failing to provide categories of information that are not called for by the special disclosure requirements relating to this initiative, as some commenters claimed. The liability provisions of the Securities Act are inapplicable to any act done or omitted in conformity with the Commission's rules.<sup>183</sup> However, the disclosure requirements under the Securities Act exist at two levels. First, responses must be provided to the specific items required by the appropriate registration form. An issuer will not be liable for failing to provide information under a heading that is not called for by the appropriate form. However, an issuer will be liable for failing to provide information that is not specifically required, but that is nevertheless material. The test of materiality is the U.S. test, and the pattern of liabilities and defenses is the U.S. pattern.

Thus, a Canadian issuer is permitted to provide merely the disclosure required by Canadian law, to the extent permitted under the rules

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obligatory, exercise in harmonizing public offering regulation, in connection with the European Community's single market program.

<sup>182</sup> As noted above, this hybrid approach is the main theme of the European Community's 1992 initiative, and is the approach of the Second Banking Directive and other single market financial regulation initiatives.

<sup>183</sup> 15 U.S.C. § 77s (1988).

issued under the MDS Release, but is still subject to potential liability for failing to state information, or for misstating information, deemed material under U.S. law, and is subject, along with its underwriters, to U.S. standards of liability. As a practical matter, Canadian issuers and their underwriters will seek to structure their disclosure to be as protective as possible under U.S. law. The underwriters will therefore engage in U.S.-style due diligence in order to establish this defense, and they will insist on a level of disclosure consistent with U.S. materiality standards. Because of this effect, the concept expressed in the MDS Release will provide only limited, but important benefits. The benefits that it will provide, for Canadian issuers offering in the United States and for U.S. issuers offering in Canada, are not so much in disclosure concessions, but in timing. The timing advantage is that a simultaneous U.S. and Canadian offering by a Canadian issuer can proceed in accordance with the Canadian timing for registration and subsequent permitted sale, instead of waiting for an independent declaration of effectiveness—the point at which securities can be sold—in the United States.

It is also important to consider the process that the Commission followed in negotiating this approach with its Canadian counterparts. The MDS Release does not evidence significant regulatory compromise on the part of the Commission. While the Commission has done an earnest job of compromising certain procedural requirements, including possibilities for Commission review of disclosure, the MDS Release evidences a careful review of foreign regulation to determine whether it satisfies all of the concerns of U.S. regulation, and to supplement the foreign regulation with additional U.S. requirements where appropriate. This approach is similar to that seen in connection with the Broker-Dealer Concept Release. The principle of reciprocity is followed only to the extent that the foreign jurisdiction—Canada—has rules that satisfy the Commission's regulatory goals. Otherwise, a principle of harmonization, or more accurately, of dual regulation, is followed.

## *2. European Community Prospectus Directive and Listing Particulars Directive*

The European Community has two main directives that deal with prospectus disclosure and filing requirements in connection with public offerings. In 1980, the Council of the European Communities adopted the Listing Particulars Directive<sup>184</sup> to harmonize disclosure requirements

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<sup>184</sup> Council Directive of 17 March 1980 Coordinating the Requirements for the Drawing Up, Scrutiny and Distribution of the Listing Particulars to be Published for the Admission of Securities to Official Stock Exchange Listing, 23 O.J. EUR. COMM. (No. L 100) 1 (1980) (Council Directive 80/

in connection with listings on securities exchanges within the Community. This was followed in 1987 with the Mutual Recognition Directive,<sup>185</sup> which amended the Listing Particulars Directive to add a limited concept of mutual recognition within the Community. This approach was extended in 1989 with the Public Offer Directive,<sup>186</sup> which extended the harmonization to public offerings made other than on an exchange.

The Listing Particulars Directive, as amended by the Mutual Recognition Directive, requires member states to ensure that listings on stock exchanges within their territories are conditional on the publication of listing particulars, or an information sheet.<sup>187</sup> The information published is required to include certain prescribed items of information, with variations in cases of particular issuers or special offering situations, as well as any other information necessary for investors to make an informed assessment of the issuer and its securities.<sup>188</sup> Member states are required to appoint a competent authority to approve listing particulars as in conformity with the requirements of the directive before they may be published.<sup>189</sup> The Listing Particulars Directive, prior to amendment by the Mutual Recognition Directive, merely required relevant competent authorities in connection with simultaneous or near simultaneous offerings on multiple Community exchanges to use their best efforts to coordinate requirements. Thus it made the first step of essential harmonization, but did not take the second step of mandatory mutual recognition of home state regulation.<sup>190</sup>

In 1987, the Listing Particulars Directive was amended by the Mu-

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390/EEC) [hereinafter *Listing Particulars Directive*]. For a detailed description of the Listing Particulars Directive and the Public Offer Directive referenced below, see Warren, *Regulatory Harmony in the European Communities: The Common Market Prospectus*, 16 BROOKLYN J. INT'L L. 19 (1990).

<sup>185</sup> Council Directive of 22 June 1987 Amending Directive 80/390/EEC Coordinating the Requirements for the Drawing-up, Scrutiny and Distribution of the Listing Particulars to be Published for the Admission of Securities to Official Stock Exchange Listing (Directive No. 87/345), 30 O.J. EUR. COMM. (No. L 185) 81 (1987) (Council Directive 87/345/EEC) [hereinafter *Mutual Recognition Directive*]. The Mutual Recognition Directive has been supplemented by Directive 90/211/EEC, Council Directive of 23 April 1990 Amending Directive 80/390/EEC in Respect of the Mutual Recognition of Public-Offer Prospectuses as Stock Exchange Listing Particulars, 33 O.J. EUR. COMM. (No. L 112) 24 (1990) (allowing for the recognition of a public offering prospectus not only as a public offering prospectus in other member states, but also as listing particulars where admission to listing is requested within a short period of time).

<sup>186</sup> Council Directive of 17 April 1989 Coordinating the Requirements for the Drawing-Up, Scrutiny and Distribution of the Prospectus to be Published When Transferable Securities are Offered to the Public, 32 O.J. EUR. COMM. (No. L 124) 8 (1989) (Council Directive 89/298/EEC) [hereinafter *Public Offer Directive*].

<sup>187</sup> *Listing Particulars Directive*, *supra* note 184, at art. 3.

<sup>188</sup> *Id.* at arts. 4, 5.

<sup>189</sup> *Id.* at art. 18.

<sup>190</sup> *Id.* at art. 24.

tual Recognition Directive to establish requirements for mutual recognition of home state regulation within the Community. The home state regulation is that of the state where the issuer has its registered office, or if it has none in the Community, where the issuer chooses.<sup>191</sup> Once approved by the home state, the listing particulars are required to be accepted by the other member states without the separate approval of their competent authorities.<sup>192</sup> Local competent authorities may, however, require that the listing particulars used in another member state include information specific to the market of such state concerning income tax, local paying agents and local publication of notices.<sup>193</sup>

The Mutual Recognition Directive predated the reciprocity debate that took place with respect to the Second Banking Directive,<sup>194</sup> and therefore does not contain specific provisions regarding the conditions for availability of the benefits of mutual recognition to issuers resident in third states. It permits member states to restrict the application of mutual recognition to issuers having their registered office in a member state. It does, however, provide that the Community may enter into agreements with third states reciprocally extending the benefits of mutual recognition to their issuers, provided that the third states' rules provide "equivalent protection to that afforded by this Directive, even if those rules differ from the provisions of this Directive."<sup>195</sup> The Public Offer Directive discussed below has similar provisions.<sup>196</sup>

The 1989 Public Offer Directive is intended to extend similar treatment in circumstances where a public offering is made but stock exchange listings are not effected. The implementation of this directive required intense negotiation, as previously Community law did not require specified disclosure prior to a public offering, but only prior to a listing on an exchange.

The Public Offer Directive requires prospectuses to be published for all public offerings within the Community.<sup>197</sup> For public offerings of securities that are to be listed on an exchange, the contents of the prospectus must comply with the Listing Particulars Directive.<sup>198</sup> It is notable that the Public Offer Directive adopts the regulatory principle that *less* detailed information should be required in connection with unlisted offer-

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<sup>191</sup> *Mutual Recognition Directive*, *supra* note 185, at art. 1.

<sup>192</sup> *Id.*

<sup>193</sup> *Id.*

<sup>194</sup> See text accompanying notes 69-95, *supra*.

<sup>195</sup> *Mutual Recognition Directive*, *supra* note 185, at art. 1.

<sup>196</sup> *Public Offer Directive*, *supra* note 186, at art. 24.

<sup>197</sup> *Id.* at art. 4.

<sup>198</sup> *Id.* at art. 7.

ings than in connection with listings, so as not to burden small and medium-sized issuers unduly.<sup>199</sup> While U.S. securities laws have similar approaches to very small offerings,<sup>200</sup> the general thrust of disclosure regulation in the United States requires less information of larger, more established issuers, or at least permits greater incorporation by reference to periodic disclosure documents, requiring smaller, less established issuers to provide the fullest disclosure.

The Public Offer Directive requires unlisted offerings to comply with a less demanding disclosure list than the Listing Particulars Directive, although it also requires that all information be provided necessary to enable investors to make an informed decision.<sup>201</sup> While prior scrutiny of prospectuses is not required for unlisted offerings within a particular member state, as it is under the Listing Particulars Directive for listed securities,<sup>202</sup> prior scrutiny is a condition for mutual recognition under the Public Offer Directive.<sup>203</sup> In connection with a simultaneous or nearly simultaneous offering in two or more member states, the competent authority of the member state in which the issuer has its registered office, if the public offering or a listing is made in that state, is charged with scrutinizing and approving the prospectus. One problem raised in connection with the Public Offer Directive is that some member states do not generally provide for prior scrutiny of prospectuses. The directive resolves this problem by providing that in the event that such a state would otherwise be charged with scrutinizing and approving the prospectus, the offeror must choose another state's competent authority where such prior scrutiny is normally effected. Subject to this condition and to translation, a prospectus must be accepted in other member states.

One significant problem with the Public Offer Directive is the scope of its exclusions, which are so extensive as to possibly obviate the utility of the directive.<sup>204</sup>

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<sup>199</sup> *Id.* at preamble paragraph 12, arts. 7, 11.

<sup>200</sup> See Rules 505 (exemption for limited offerings not exceeding \$5,000,000) and 504 (exemption for small issues not exceeding \$500,000), which provide exemptions from the registration requirements of the Securities Act. 17 C.F.R. §§ 230.504, 230.505. Rule 505 imposes no specific disclosure requirements, although it does not provide exemptions from the antifraud provisions. See also Regulation A under the Securities Act, 17 C.F.R. §§ 230.251-230.260.

<sup>201</sup> *Public Offer Directive*, *supra* note 186, at art. 11.

<sup>202</sup> *Listing Particulars Directive*, *supra* note 184, at art. 18.

<sup>203</sup> *Public Offer Directive*, *supra* note 186, at arts. 20, 21.

<sup>204</sup> See Warren, *supra* note 184, at 38-40 for an explanation of these exemptions. Excepted are eurobonds and euroequities, private placements, small offerings, certain wholesale offerings, employee offerings and exchange offers.

3. *Regulation S, the Reciprocal Prospectus Initiative and the European Community Prospectus Initiatives*

As noted above, Regulation S is a U.S. administrative effort to divide up global prescriptive jurisdiction for purposes of the procedural registration requirements of the U.S. securities laws. It determines unilaterally under what circumstances these U.S. laws will apply to foreign securities offerings, and under what circumstances they will not. From the standpoint of addressing the problems raised by the contradiction between national regulation and transnational finance, it takes a relatively insular and introspective approach. On the other hand, instead of addressing these problems by unilaterally determining which state's laws shall govern, the Reciprocal Prospectus Initiative and the European Community initiatives bilaterally or regionally seek to adopt mutual recognition, relying on a degree of harmonization of rules: essential harmonization, with differing standards as to what is essential. The Reciprocal Prospectus Initiative implements limited mutual recognition, based on limited harmony of legal standards. The Listing Particulars Directive and the Public Offer Directive, on the other hand, take a more complete approach, providing for complete harmonization, at least in selected areas, and for complete mutual recognition.

These approaches are based on a relatively high degree of agreement on regulatory purposes: requirements for adequate disclosure to support accurate investment and capital allocation, combined with some level of government scrutiny of disclosure practices and liability for faulty disclosure. While public offering regulation contains a risk of regulatory arbitrage and consequent competition in regulatory laxity, the direction of flow is not as clearly indicated as perhaps in areas such as financial institution powers or capital.

V. CONCLUSION

This article has considered several recent developments in financial regulation. This consideration has focused on the difficult issues relating to the sometimes countervailing substantive concerns for regulatory effectiveness and for competitiveness in international business, as well as the procedural concerns relating to cooperation, consistency and proper authorization.

The unilateral, regional and multilateral initiatives described in this article all seek to address the mismatch between transnational finance and national financial regulation. They can be viewed from at least three perspectives:

First, as issues of regulatory scope, in which an earnest regulator seeks only to fulfill his or her regulatory mandate, without other concerns for issues of competitiveness or cooperation;

Second, as issues of trade in services, in which regulators must be sensitive to the trade concerns of domestic and foreign constituents; and

Third, as issues of economic integration, wherein the principle of subsidiarity—of regulation at appropriate levels—and of competition and cooperation in regulation, as well as of the degree to which regulation must mesh with a particular society, are played out.

Only by considering all three of these perspectives, and by ensuring that the process used to address international financial regulation issues allows for negotiation taking into account all three of these perspectives, will it be possible to develop solutions to problems of international financial regulation.

From a purely legal standpoint, this problem can be described as one of regulatory scope or prescriptive jurisdiction: which country's law should govern a particular institution or transaction? However, even if this legal issue could be resolved, the results would not necessarily make sense, as a multiplicity of independent regulatory regimes could be an inefficient means of social control over increasingly transnational finance. Global homogeneity of regulation is not necessarily optimal either, as finance regulation must mesh with each society's particular circumstances, and as opportunities for variation, and thus for greater innovation and competition, in finance regulation are desirable. The initiatives described herein illustrate a variety of procedural approaches to this problem, and a variety of policy considerations applied. These procedural approaches and policy considerations interact in complex ways in each case.

The policy considerations added to domestic policy discourse in the context of international regulation include, as noted at the beginning of this article, the substantive considerations of competitiveness and regulatory effectiveness, as well as the more procedural factors of cooperation and consistency in relations with other countries. These policy considerations influence and interface with the procedural approach adopted.

#### A. Competitiveness

We have seen that competitiveness has played a significant role in the formulation of Regulation K, which appears to limit the foreign operations of foreign banks operating in the United States in order to avoid



providing better than national treatment in a way that reduces the domestic competitiveness of U.S. banks. Regulation K also provides expanded powers to U.S. banking organizations in their foreign operations in a way that belies the need for powers limitation domestically, due to competitive pressures abroad. Regulation K can be viewed as a means to apply U.S. regulatory hindrances, to some extent, to foreign banking organizations in their foreign operations, using as a jurisdictional basis the fact that the foreign banking organization does business in the United States. Thus, Regulation K fights a rearguard action against more liberal foreign regulation.

On the other hand, the Second Banking Directive, in its operation within the European Community, is intended to harness the liberalism of foreign regulation as a competitive discipline on local member state regulation. Under this aspect of the Second Banking Directive, regulatory effectiveness is a determining factor of international financial regulation policy only insofar as the regulatory goal sought to be achieved has been the subject of essential harmonization; otherwise, free competition is the determining factor. Regulation cannot otherwise be used intentionally or unintentionally as a barrier or hurdle to foreign trade in financial services. Regulation K is a unilateral dictate that does little to recognize the possible merits of foreign regulation, whereas the Second Banking Directive provides a regional process or forum for dialog and competition in regulation.

The Riegle-Garn Bill differs from both Regulation K and the Second Banking Directive in that it explicitly is a trade measure, with no independent regulatory role. It seeks reciprocity, based on an economic perspective that openness by the United States is a detriment only to be accepted in exchange for openness by the relevant trading partner. Of course, while this type of measure may help to open foreign markets, it (like the reciprocity provisions of the Second Banking Directive) is also open to misuse to close domestic markets. The Riegle-Garn Bill rejects multilateralism (as through the GATT) as the appropriate approach to opening foreign markets.

On the other hand, Rule 15a-6 and Regulation S appear devoid of trade motivation: the Commission appears as earnest regulator, merely trying to protect the integrity of the U.S. capital allocation mechanism. However, by attaching significant U.S. legal consequences to what may be relatively insignificant U.S. contacts, without adjustment, they place burdens on international finance. Rule 15a-6 appears more problematic in this regard, as it relates to institutional—broker-dealer—regulation, as opposed to Regulation S, which relates to transactional regulation. On

the basis of a single U.S. relationship, a foreign broker-dealer could be required to comply with the full panoply of U.S. broker-dealer regulation. The Commission has shown an interest in moving away from this type of result in its recent proposals relating to tender offers and rights offers, but has not been under similar pressure to relinquish jurisdiction in other areas. The Commission has been motivated by a broad trade consideration: enhancing the competitiveness of the U.S. economy as a whole, and of U.S. investors in particular, by providing greater access to outside sources and uses of finance without prejudicing capital import neutrality by imposing U.S. regulatory costs on transactions that are essentially foreign.

### B. Regulatory Effectiveness

Regulatory effectiveness is linked with competitiveness. It appears that the ability to maintain and apply regulation that is in excess of the regulation of other countries, which may be viewed as a category of regulatory effectiveness, is increasingly sacrificed to achieve greater competitiveness and greater cooperation with other countries. This makes sense, but also raises some concerns. The concerns are for the diminished ability to achieve the appropriate social goals of regulation, whatever they may be.

One way in which the ability to achieve the goals of regulation is diminished is through regulatory arbitrage, the shifting of assets or operations in a manner designed to minimize the costs or effects of regulation. Regulatory arbitrage is self-conscious structuring of assets or operations. But even without self-conscious structuring, the increasing internationalization of business makes it harder for a single regulator to apply its rules in a way that is effective to achieve the relevant goals, or to supervise and enforce compliance with its rules. The BCCI scandal has been cited as an instance of failure to coordinate supervision effectively in the face of self-conscious structuring to avoid supervision. One prong of the QFBO test contained in Regulation K, and part of the test for mutual recognition under the Broker-Dealer Concept Release, seeks to ensure that local persons are not using a foreign vehicle to shop for a less costly regulator. The Second Banking Directive contains this concept as well.

Of course, not all regulation is good; some was not accurately formulated when made, some is outdated and some seeks to achieve goals that may not be appropriate, such as subsidization of a particular business. Unless an explicit or implicit dialog with foreign regulators is maintained, the discipline and ideas that can help reform domestic regulation will not be available. Thus, the negotiations toward cooperation

can help each regulator to re-examine its own approach in light of the experience of others. In this sense, cooperation both facilitates and requires the compromise of idiosyncratic regulatory principles.

Even if all regulation were good, it is important to recognize that overlaps of regulation—double regulation—may impose excessive costs on enterprise. Yet until clear conflict of law rules for regulators are formulated, as the European Community and the Basle Committee have sought to do, these costs cannot be eliminated. The willingness of the United States to project its regulation abroad to cover the foreign activities of its persons or persons who have other links to the United States diminishes the ability of other countries to provide capital import neutrality in their regulation. The failure of international law, of the U.S. Constitution and of many statutes to provide clear conflict of law rules for regulators results in these overlaps.

### C. Consistency

The failure of law to provide clear conflict of law rules for regulators, and the failure of U.S. regulators to coordinate more completely to present an integrated view of the scope of U.S. regulatory jurisdiction, results in possibilities for confusion and opportunism. This coordination is enhanced by coordination between the Basle Committee and IOSCO.<sup>205</sup>

Regulation K applies U.S. bank regulation to overseas operations of U.S. banking organizations on the basis of U.S. nationality or U.S. nationality of shareholders, and applies U.S. bank regulation to overseas operations of foreign banking organizations on the basis of U.S. operations. Obviously, this approach results in overlap. Rule 15a-6 purports to apply U.S. broker-dealer regulation to an entire foreign broker-dealer organization, despite only a small amount of U.S. business. The overlaps seem more problematic in the area of institutional regulation than in the area of transactional regulation, such as the registration requirements under the Securities Act.

Regulation S would apply the U.S. registration requirements to a public offering where only a small portion of the shares are publicly offered in the United States; this approach also will result in overlapping public offering regulation. In addition, while Regulation S clarifies the conflict of law rules with respect to the registration requirements, it declines to provide any guidance as to the applicability of the antifraud

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<sup>205</sup> See, e.g., Thomson's Int'l Banking Regulator, Sept. 27, 1991, at 1 (reporting coordination between IOSCO and the Basle Committee on capital requirements for securities operations of banks and brokerage houses, as they relate to foreign exchange exposure).

provisions of the securities laws. The Reciprocal Prospectus Initiative has a similar shortcoming.

In addition, a deeply held principle of U.S. tax jurisdiction is that U.S. citizens should be subject to taxation on their worldwide income, regardless of foreign residence. This principle was inconsistent with the focus of Regulation S on the residence, rather than the citizenship, of purchasers of securities. The maintenance of this principle has reduced the utility of Regulation S as a means to provide unilateral conflict of law rules with respect to the registration requirements under the Securities Act and thereby enhance capital market efficiency, because the TEFRA D tax requirements call for more extensive and burdensome procedures.

#### D. Cooperation

The procedural approaches to cooperation are determined by the context in which the cooperation is developed: (i) unilateral without reciprocity requirements, such as Regulation K, Rule 15a-6 or Regulation S; (ii) unilateral with reciprocity requirements, such as the externally-oriented features of the Second Banking Directive or the features proposed to be added to U.S. law by the Riegle-Garn Bill; (iii) bilateral reciprocal agreements, such as the U.S.-Canadian multijurisdictional disclosure system; (iv) regional with the constitutional and institutional infrastructure of the European Community, with no conditions or opportunities for defection based on reciprocity; and (v) multilateral non-binding, loosely reciprocal agreements in the Group of Ten or in IOSCO. The GATT services negotiations constitute another forum. Additional variations are of course possible.

As indicated above, cooperation with foreign regulators requires a recognition of the mutability of domestic regulation: a denial of regulo-centrism. It also opens up the contingency of domestic regulation, and allows its re-examination in light of foreign experience.

The underlying difficulty in this exercise is in identifying the appropriate social goals of regulation. Those goals that are easier to universalize, such as disclosure regulation in the securities field, or capital regulation in banking, may be the basis for cooperation that can alleviate concerns for regulatory effectiveness by maintaining agreed standards, or by providing for assistance in surveillance and enforcement. In order to achieve cooperation, it is necessary to resolve regulation, not to its lowest common denominator, but to its most efficient commonly acceptable level. However, efficiency is determined by reference to the ability of regulation to achieve social goals, and each country will have differing social goals, depending on a variety of factors. On the other hand, some

types of goals are universal, and some types of institutional or legal means of achieving those goals are more efficient than others. The institutional and constitutional infrastructure of the European Community, and its common goals of integration, provide impetus for accelerated universalization within the Community, which in turn enhances the ability to cooperate internally. This institutional and constitutional infrastructure includes the ability to legislate and adjudicate member state defections from the principles of free movement of capital and free trade in services. It may be compared with the soft legislation and non-existent adjudication capacities of the Group of Ten and of IOSCO, and with the weak legislative and adjudicative capacities of GATT.

The mode and potential success of cooperation will depend on factors such as the degree of universality of goals, the severability of the area of regulation from other aspects of social structure, the type of regulation involved, perceptions as to its importance for sovereignty and importance for local control, and the institutional and constitutional infrastructure for cooperation.

Finally, as enhanced cooperation requires the compromise and resolution of domestic regulatory goals and methods, it is necessary that cooperation be effected at the level of authority competent to do so. Neither the Commission nor the Board has been delegated full competence to do so, nor should they be. Rather, they should cooperate with other administrative organs to propose treaty or legislative solutions. It is for Congress to determine how our policies should be compromised in order to integrate our economy with the international system.

Finance is central to enterprise. As more countries move to free their enterprise, they must also free their finance. The free transnational flow of finance, and thus of enterprise, will help to spread jobs and wealth, as well as to increase aggregate wealth. This phenomenon can be facilitated by a dove-tailed effort to diminish regulatory barriers to the free flow of capital and to enhance the accuracy of the allocation of capital through efficient regulation.