Touro Law Review

Volume 2 | Number 1 Article 3

1986

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In recent years an increasing number of foreign banking corporations (foreign banks) have raised capital through sales of securities in the United States or are considering doing so.[1] This article is intended to provide a working guide to the principal legal considerations involved in capital-raising techniques currently favored by foreign banks and in capital-raising techniques likely to become popular with foreign banks in the future.

The article will briefly discuss the reasons for current foreign bank participation in the United States capital markets. Thereafter, the article will analyze various types of securities offerings made directly and indirectly in the United States by foreign banks and will review the principal legal issues raised in connection with those offerings under federal and state securities laws, federal banking laws, federal tax laws, and certain other laws and regulations.

I. Reasons for Participation in the United States Capital Markets

Foreign banks have sought to raise funds in the United States capital markets for two related but different purposes. One purpose has been the financing of the foreign bank's operations generally, in which case the funds obtained in the United States capital markets have been used primarily outside the United States. The other purpose has been the financing of the foreign bank's activities in the United States, in which case the funds obtained have been used primarily in the United States. While both of these purposes can be accommodated by a variety of financing techniques, the particular purpose for which funds are to be raised may direct the foreign bank towards particular financing techniques.

A. Funding General Operations

A foreign bank seeking to fund its operations generally through sales of securities in the United States capital markets is concerned primarily with the nature of the markets themselves and the benefit they would provide to a foreign bank. The United States capital markets offer several advantages to a foreign bank.

Perhaps the most important advantage is that the United States provides a ready source of capital outside the foreign bank's home

1. For purposes of this article, a foreign banking corporation is a depository institution that is licensed to take deposits and make loans, that is not a foreign government or political subdivision thereof, and that is organized in a manner similar to banking corporations in the United States.

market. Except for the Euromarket, many foreign capital markets are small in comparison to the United States capital markets. These smaller markets do not have the depth necessary to accommodate all market participants, especially if the public sector is a heavy borrower in the market.[2] In contrast, the United States capital markets have sufficient size and depth to accommodate substantial public and private sector borrowing demand. In addition, a growing interest among United States institutional investors, particularly pension funds, in diversifying their portfolios to include foreign securities appears to have increased the receptivity of the United States capital markets to securities offerings by foreign banks.[3]

Raising capital in the United States also may serve a foreign exchange function. Foreign banks seeking to raise capital to fund their United States operations or the United States activities of their clients often may find it advantageous to raise funds in the United States in order to avoid the cost of converting other currencies into United States dollars. Raising dollar capital may also assist a foreign bank or its clients in repaying previously incurred debt denominated in United States dollars.

B. Funding United States Operations

Many foreign banks participate in the United States capital markets in order to obtain funding for the bank's United States operations. A foreign bank's recourse to the United States capital markets may be a response to attractive borrowing opportunities or may be compelled by laws of the foreign bank's home country prohibiting the use outside of the home country of funds raised there.[4]

According to a recent survey of foreign banking in the United States published by *The American Banker*,[5] as of mid-1985, there were an aggregate of 940 banking offices in the United States established by 256 foreign banks.[6] These offices included branches, agencies, commercial bank subsidiaries, Edge Act corporations,[7] New

2. Osborn, *Why Europe Is Coming to New York*, EUROMONEY 77, 78 (Nov. 1983) [hereinafter cited as *Osborn*].

3. Lim, *Look What's Happening to Equities*, EUROMONEY 184 (Oct. 1983). *See generally* Eplich, *International Diversification by United States Pension Funds*, 6 FED. RESERVE BANK OF NEW YORK Q. REV. No. 31 (1981).

4. Osborn, *supra* note 2, at 78.

5. *Foreign Banking In The U.S.*, Am. Banker, Feb. 14, 1986, at 1A-24A.

6. *Id.* at 2A-3A.

7. Edge Act corporations are United States corporations organized for the purpose of engaging in international or foreign banking or financial operations.

York State investment companies, finance companies and representative offices. A year earlier, in mid-1984, there were an aggregate of 906 banking offices in the United States established by 251 foreign banks.[8] At mid-1985, offices of foreign banks in the United States had assets of approximately $423.8 billion, which represented an increase of 11.3 percent over the previous year and amounted to approximately 18.4 percent of the assets of all United States banks.[9]

Most foreign banks establishing operations in the United States do so in order to conduct existing business in a new market and in order to serve existing home country clients conducting business in the United States. Services to home country clients may include financing, business introductions and coordination of financial services. Foreign banks operating in the United States may also facilitate the trading activities of home country public sector entities. In addition, foreign banks may provide a haven to certain home country investors seeking to place their funds in the United States to escape possible political and economic turmoil.

In the same way that foreign banks facilitate the business of clients from the home country in the United States, foreign banks are able to help United States entities operating in its home country. The foreign bank is in a good position to offer United States clients and investors advice about investment opportunities and business conditions in its home country. Also, the foreign bank is often in a good position to reduce the foreign currency exposure of United States clients engaged in home country activities by assisting the clients in obtaining financing in the home country currency.

Foreign banks find that a United States office may lead to important business opportunities. One of the most significant is the ability to participate in loan syndications managed by United States money center banks. Foreign banks may use a United States office to set up or expand foreign exchange operations, including the clearing of dollar transactions for affiliates of the foreign bank. Also, a foreign bank with a United States office can provide assistance, including the management of overnight funds held in the United States, to smaller home country financial institutions and banks in their foreign exchange and investment activities in the United States. In addition, the expansion of business into additional jurisdictions and

8. *Foreign Banking In The U.S., supra* note 5, at 2A-3A.

9. Cacace, *Foreign Banks Hungry for U.S. Commercial Loans*, Am. Banker, Feb. 14, 1986, P. 1, col. 4, at 38, col. 1.

banking markets provides the foreign bank with an opportunity to diversify country and business risk.[10]

Finally, the exposure afforded by participation in the United States capital markets may be advantageous to some foreign banks. Heightened awareness of a foreign bank from offerings of its securities may assist the institution in marketing its services and products in the United States. Once investors become familiar with a particular issuer, it is often easier for the issuer to raise additional capital in subsequent offerings of securities in the United States. In some cases, the offering of securities in the United States also lends legitimacy to the securities of a foreign bank in its home country market and creates new demand there for the issuer's securities.[11]

II. Principal Methods of Raising Capital

There are three principal methods by which a foreign bank may raise capital through securities offerings in the United States. First, the foreign bank may offer and sell its own securities directly in the United States. Second, a United States finance or other subsidiary of the foreign bank may offer securities in the United States. Third, a United States branch or agency of the foreign bank may offer its securities in the United States. In each case, the proceeds from the offering may be used either in the foreign bank's non-United States operations or in the United States operations of the foreign bank or its subsidiary, branch, or agency.

The method selected by a foreign bank to raise capital in the United States will depend, in large part, on internal business considerations, such as whether the foreign bank has United States operations that require capital support and whether it desires to engage in banking or other business activities in the United States. In addition, however, the decision to select a particular method of capital raising may depend on the legal constraints imposed by United States laws.

A. Securities Issued Directly by Foreign Banks

1. *Types of Securities Offerings*

In general, the federal securities and banking laws of the United States permit a foreign bank to issue equity or debt securities in the

10. Goldberg, *The Determinants of Foreign Banking Activity in the United States*, 5 J. Banking & Fin. 17, 21 (1981).

11. Osborn, *supra* note 2, at 78 (quoting statement of Mr. James McLaren, Vice President, Goldman, Sachs & Co.).

United States. Many recent public offerings by foreign nonbank corporations in the United States have been offerings of equity securities.[12] Foreign banks wishing to issue equity securities, including preferred or common stock and debt securities convertible into stock, may benefit from the fact that a demand for equity securities of foreign corporations already exists in the United States.

To date, however, foreign banks raising capital in the United States have done so predominantly by issuing non-convertible debt instruments. One likely reason for this result is that offerings of certain debt instruments are exempt from registration under both the Securities Act of 1933, as amended (Securities Act), and the Securities Exchange Act of 1934, as amended (Exchange Act).[13] Whether a foreign bank proposes to issue debt or equity securities, however, it generally will need to request an exemption from the Securities and Exchange Commission (SEC or Commission) under the Investment Company Act of 1940, as amended (Investment Company Act).[14] Foreign banks have requested and received exemptions under the Investment Company Act for the issuance in the United States of bankers' acceptances, commercial paper, medium- and long-term notes, and other debt securities.[15]

To date, no foreign bank or its parent holding company or its subsidiary has received an exemption under the Investment Company Act for the issuance of common stock (other than offerings to employees); however, recently two foreign banks and a foreign bank holding company requested exemptive orders under the Investment Company Act to permit them to make public offerings of equity securities or American Depository Receipts (also known as American Certificates or ADRs) for equity securities in the United States.[16] At

12. A printout dated March 28, 1986 provided by the SEC's Directorate of Economic and Policy Analysis for a computer analysis of registration statements available for foreign registrants under the Securities Act of 1933 reveals that, from January 1, 1985 to December 31, 1985, 169 were for equity securities (common stock, preferred stock or warrants), and two were for debt instruments (notes, debentures, bonds or convertible debt instruments).

13. For the Securities Act *see* 15 U.S.C. §§ 77a-77aa (1982) and *infra* notes 22-138 and accompanying text; for the Exchange Act *see* 15 U.S.C. §§ 78a-78kk (1982) and *infra* notes 139-66 and accompanying text.

14. 15 U.S.C. §§ 80a-1 to 80a-64 (1982). *See infra* notes 167-248 and accompanying text.

15. *See, e.g., In re* Christiania Bank Og Kreditkasse, SEC Investment Co. Act Release No. 12,828 (Nov. 18, 1982), 47 Fed. Reg. 49,123 (1982); *In re* Lloyds Bank Int'l Ltd., SEC Investment Co. Act Release No. 11,778 (May 18, 1981), 46 Fed. Reg. 22,843 (1981); *In re* Continental Bank of Canada, SEC Investment Co. Act Release No. 11,479 (Jan. 5, 1981), 45 Fed. Reg. 81,910 (1980); *In re* Svenska Handelsbanken, SEC Investment Co. Act Release No. 10,816 (Aug. 7, 1979).

16. National Westminster Bank PLC, File No. 812-6287 (Jan. 21, 1986); Westpac Banking Corporation, File No. 812-6288 (Jan. 24, 1986); Barclays PLC, File No. 812-6306 (Feb. 21,

this writing the SEC has not taken action on the requests and it is therefore uncertain whether a foreign bank would be able to obtain an exemption under the Investment Company Act to offer its equity securities in the United States.

Foreign banks' most frequent source of capital in the United States has been the United States commercial paper market, in which foreign banks have become significant participants.[17] The domestic commercial paper market is attractive to foreign banks because it provides an additional source of funding and, consequently, additional liquidity and flexibility, a source of less expensive funds than might be available with other short-term financial instruments, and an opportunity for the bank to establish name recognition in the United States.[18]

Securities, particularly equity securities, of foreign issuers including foreign banks are sometimes represented in the United States by ADRs.[19] There are two circumstances under which ADRs may be issued. First, a foreign bank may wish to make a public offering of its equity securities in the United States through the use of ADRs. Second, a foreign bank which expects United States securities holders to encounter difficulty in holding or trading the foreign securities directly may wish to establish ADRs for its equity securities to facil-

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1986). The SEC has granted at least one exemption for debt securities that also covered possible future offerings of preferred stock by a foreign developmental bank. *In re* Australian Resources Dev. Bank Ltd., SEC Investment Co. Act Release No. 10,629 (March 15, 1979), 44 Fed. Reg. 17,843 (1979).

Subsequent to the submission of this article for publication, the SEC granted the exemptions applied for by Westpac Banking Corporation, SEC Investment Co. Act Release No. 15,217 (July 23, 1986) and Barclays PLC, SEC Investment Co. Act Release No. 15,228 (July 28, 1986).

17. *See generally* Goodman & Worth, *Foreign Bank Entry into the U.S. Commercial Paper Market*, 165 BANKERS MAG. No. 6, 36 (1982).

18. *Id.* at 37.

19. An American Depositary Receipt (ADR) is a negotiable receipt issued in registered form by a depositary, usually a United States banking institution, against deposits with it (or a foreign custodian) of securities issued by a foreign corporation. The ADR, therefore, serves as a form of "substitute security" and is designed to facilitate trading in the foreign security in the United States. *See infra* notes 153 and 404-05.

The principal purpose of an ADR is to avoid cumbersome foreign securities transfer requirements, delays in transfers caused by overseas mails, foreign securities transfer taxes, and other inconvenient requirements of foreign law. In addition, an ADR may facilitate a holder's receipt of dividends, particularly with respect to dividends that are not sent to securities holders but that must be collected by the holder after public notice of a dividend declaration is made by the foreign issuer. In this event, the depositary will monitor foreign periodicals for dividend declaration notices, collect the dividend, and distribute the dividend to ADR holders. The depositary also may perform a similar function in connection with other issues relating to shareholders, such as voting on matters affecting the corporation.

itate their trading in the secondary market in the United States. In either circumstance, the ADRs are deemed to be separate securities from the underlying foreign securities and, therefore, may be subject separately to the federal securities laws.[20]

2. *The Federal Securities Laws*

The offer, sale, and subsequent trading of securities issued by a foreign bank in the United States are subject principally to the Securities Act, which regulates the offer and sale of securities in the United States; the Exchange Act, which regulates the trading of securities in the secondary markets; the Investment Company Act, which regulates the activities of investment companies (a term that the SEC has interpreted to include foreign banks); and the Trust Indenture Act of 1939, as amended (Trust Indenture Act), which subjects certain offerings of debt securities to special requirements supplemental to those of the Securities Act.[21] Activities within the purview of these statutes are regulated by the SEC and also, in the case of the Exchange Act, by certain self-regulatory organizations such as the New York Stock Exchange, Inc. (NYSE) and the National Association of Securities Dealers, Inc. (NASD).

a. *The Securities Act*

i. *Registration Requirements*

The Securities Act, which is generally applicable to offers and sales of securities in the United States, requires that, absent an available exemption, securities be offered and sold only pursuant to a registration statement containing detailed information about the issuer, the securities being offered and the offering transaction.[22] To implement the provisions of the Securities Act, the SEC has promulgated a body of rules and established a series of registration forms, which include special provisions for issuers that qualify as foreign private issuers.[23] Unless a foreign bank is a government entity or is

20. *See infra* notes 140-41, 153, 404-05 and accompanying text, and note 390. *See also supra* note 16. The exemptive requests cited there included requests for exemptions to permit the issuance of ADRs.

21. 15 U.S.C. §§ 77aaa-77bbbb (1982).

22. *See* Section 5 of the Securities Act. *id.* § 77e.

23. Rule 405 under the Securities Act, in relevant part, defines the term "foreign private issuer" to mean:

> any foreign issuer other than a foreign government except an issuer meeting the following conditions: (1) more than 50 percent of the outstanding voting securities of such

only nominally a foreign corporation, it should qualify as a foreign private issuer.

Absent the availability of an exemption from registration, a foreign bank that offers its securities in the United States is required to register the offering under the Securities Act by filing with the SEC a registration statement on one of the registration forms available to foreign private issuers.[24] The registration statement must be reviewed and declared effective by the SEC before the securities may be sold.

As discussed below, however, there are several means by which a foreign bank may avoid the registration requirements of the Securities Act. First, the provisions of the Securities Act do not apply to instruments issued by the bank that are not "securities." Second, the Securities Act provides various exemptions from registration for certain types of securities and for certain types of securities offerings. The most relevant exemptions for a foreign bank are (1) the exemption for short-term commercial paper discussed in subsection iii below, (2) the exemption for securities guaranteed by a United States bank discussed in subsection iv below and (3) the exemption for securities sold in a private transaction discussed in subsection v below.

The liabilities imposed by the Securities Act on issuers making registered or exempt offerings of securities in the United States are discussed briefly in subsection vi below. In addition, the disclosures required in connection with an offering of securities registered under the Securities Act by a foreign bank are discussed in section III below.

ii. *Definition of Security*

The term "security" is defined by Section 2(1) of the Securities Act to include, among other things, any stock, note, bond, debenture, evidence of indebtedness, investment contract, certificate of deposit

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issuer are held of record either directly or through voting trust certificates or depositary receipts by residents of the United States; and (2) any of the following: (i) the majority of the executive officers or directors are United States citizens or residents, (ii) more than 50 percent of the assets of the issuer are located in the United States, or (iii) the business of the issuer is administered principally in the United States.

17 C.F.R. § 230.405 (1985). *See also* Rule 3b-4(c) under the Exchange Act, *id.* § 240.3b-4. Both Rule 405 and Rule 3b-4 define the term "foreign government" to mean "the government of any foreign country or of any political subdivision of a foreign country" and the term "foreign issuer" to mean "any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country." *Id.* §§ 230.405, 240.3b-4.

24. *See infra* notes 389-403 and accompanying text.

for a security, receipt for a security, or guarantee of a security.[25] The statute, therefore, by its terms, applies to equity instruments (such as preferred or common stock), to debt instruments (such as commercial paper notes and other notes or bonds), to certificates of deposit for or receipts for other securities (such as ADRs), and to guarantees of any security issued by another issuer.[26]

Despite the literal terms of the statute, on occasion the courts have determined that instruments which might seem to be securities for purposes of the Securities Act are, nevertheless, not the type of instruments intended to be regulated by that statute. For example, in a 1982 decision, *Marine Bank v. Weaver*,[27] the United States Supreme Court held that a certificate of deposit issued by a state-chartered United States bank that was insured by the Federal Deposit Insurance Corporation (FDIC), although possibly a security in certain contexts, should not be considered a security for purposes of the anti-fraud provisions of Section 10(b) of the Exchange Act.[28] The Court's

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25. Section 2(1) of the Securities Act provides:

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1982).

26. *See infra* notes 39, 69-71, and 258-63 and accompanying text (concerning the applicability of the Securities Act to guarantees of securities by a foreign bank).

27. 455 U.S. 551 (1982).

28. *Weaver*, 455 U.S. at 555. Although the Court focused on the definition of the term security contained in the Exchange Act, it noted that "the definition of security in the [Exchange] Act is essentially the same as the definition of security in § 2(1) of the Securities Act of 1933. . . ." *Id.* at 555 n.3. Moreover, the SEC, in its *amicus* brief filed jointly with the bank regulatory agencies, specifically argued that neither the Exchange Act nor the Securities Act should apply to deposit instruments of federally-regulated banks. Brief for the United States as *Amicus Curiae*. *See Weaver*, *id.* at 557 n.6.

Weaver specifically leaves open the possibility that certificates of deposit may be securities in certain circumstances. *Id.* at 560 n.11. Citing this provision of *Weaver*, the Court of Appeals for the Second Circuit recently held certificates of deposits to be securities when offered pursuant to a program sponsored by a broker-dealer in which the broker-dealer, among other things, negotiated with issuers the interest rate for the certificates of deposit, investigated and monitored the creditworthiness of the issuers, and agreed to create and maintain a secondary market for the certificates of deposit. Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 84-7541 (2d Cir. Feb. 21, 1985).

ruling was premised on the view that, in that context, the purchasers of the certificates of deposit were adequately protected by the federal banking laws.

Weaver appears to turn on a combination of two factors. First, the Court noted that the issuing bank was subject to a comprehensive set of federal regulations, including reserve, reporting, and inspection requirements. Second, the Court noted that, while a security holder normally assumes the risk of an issuer's insolvency, the scheme of federal banking regulation virtually guaranteed a holder of the bank's certificates of deposit "payment in full." The Court recognized that, although the certificate of deposit involved was only partially insured by the FDIC,[29] since 1933 nearly all failing banks insured by the FDIC have received payment in full, even for portions of their deposits above the amount insured.[30] *Weaver*, therefore, left open the possibility that certificates of deposit and other deposit instruments of non-federally regulated or insured banks, including those of foreign banks, may not be securities.

The first case since *Weaver* to consider the issue of whether deposit instruments of a foreign bank are securities for purposes of the federal securities laws was *Wolf v. Banco Nacional de Mexico*.[31] The district court in *Wolf* determined that the rationale followed in *Weaver* did not apply to time deposits issued by a Mexican commercial bank and, therefore, found the instruments to be securities as defined by the Securities Act.[32] The district court based its reasoning on, among other things, the fact that Mexican reserve, reporting, and inspection requirements were distinguishable from the federal regulatory scheme to which the United States bank in *Weaver* was subject.[33]

The district court, however, was reversed on appeal.[34] The Court of Appeals for the Ninth Circuit determined that the issue of whether a bank certificate of deposit should be deemed a security

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29.. The Supreme Court, after indicating that the Weaver certificate of deposit had a denomination of $50,000, stated that: "When [plaintiffs] purchased the certificate of deposit, it could only be insured up to $40,000 by the FDIC." *Weaver*, 455 U.S. at 553 n.1. FDIC insurance limits have since been raised to $100,000. *See* 12 U.S.C. § 1821(a)(1) (1982).

30. *Weaver*, 455 U.S. at 558.

31. 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 105 S. Ct. 784 (1985).

32. 549 F. Supp. 841 (N.D. Cal. 1982), *rev'd*, 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 105 S. Ct. 784 (1985).

33. The district court also distinguished *Weaver* on the grounds that the plaintiff in *Wolf* assumed the risk of loss resulting from currency devaluation and, therefore, was not virtually guaranteed payment in full on his certificate of deposit. *Wolf*, 549 F. Supp. at 845.

34. 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 105 S. Ct. 784 (1985).

should turn not on whether the issuing bank is regulated by the United States government, but rather on whether regulation of the bank is sufficient to eliminate virtually any risk that insolvency will prevent the bank from repaying its certificates of deposit in full. Despite the absence of insolvency insurance in Mexico at the time *Wolf* arose, the court noted that no Mexican bank had ever failed and determined that government regulation imposed on Mexican banks provided its depositors with the same assurances of repayment in full afforded depositors in federally-insured banks in the United States.[35] Accordingly, the Court of Appeals applied the rationale in *Weaver* and concluded that certificates of deposit in the Mexican bank were not securities for purposes of the Securities Act.

Although *Wolf* suggests that certificates of deposit issued by well-regulated foreign banks need not be considered securities under the federal securities laws, the case is not dispositive of the issue. In the first place, *Wolf* requires that, in each case that arises in the future, a foreign bank prove the sufficiency of its government's scheme of regulation over banks before the bank's certificates of deposits can be found not to constitute securities.[36] This requirement of a country-by-country analysis provides little certainty as to how the analysis in *Wolf* would be applied to banks in countries other than Mexico. Moreover, because the United States Supreme Court declined to review *Wolf*, it remains possible that another court of appeals, or ultimately even the Supreme Court, would disagree with the reasoning followed in *Wolf*.

As a result, a foreign bank may be at risk if it relies on *Wolf* to offer its certificates of deposit in the United States without registration under the Securities Act on the grounds that they do not constitute securities.[37] A foreign bank, nevertheless, might be able to issue its certificates of deposit pursuant to one of the exemptions from registration discussed below.

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35. Noting that the loss suffered by the plaintiff in *Wolf* was the result of currency devaluation rather than the insolvency of the bank, the court of appeals further determined that the risk of currency devaluation was not the sort of risk that a depositor in a federally-regulated United States bank would be protected against and, therefore, dismissed this issue as irrelevant to its consideration. *Wolf*, 739 F.2d at 1462.

36. *See* 739 F.2d 1458, 1463 (9th Cir. 1984), *cert. denied*, 105 S. Ct. 784 (1985).

37. *See infra* notes 344-50 and accompanying text (concerning the applicability of *Weaver* and subsequent cases to certificates of deposit issued by United States branches and agencies of foreign banks).

iii. *Exemption for Commercial Paper*

Even though certificates of deposit and other debt instruments issued by a foreign bank may fall within the definition of a security under the Securities Act, Section 3(a)(3) of the Securities Act provides an exemption from the Securities Act's registration requirements for certain short-term commercial paper.[38] The Section 3(a)(3) exemption is available to any issuer, including a foreign bank, whose commercial paper satisfies the requirements for the exemption.[39]

The two principal statutory requirements for the exemption are (i) that the commercial paper, and any renewal of the commercial paper, not have a maturity at the time of issuance exceeding nine months, exclusive of days of grace (Nine-Month Requirement), and (ii) that the commercial paper arise out of, or the proceeds of the commercial paper be used for, current transactions (Current Transactions Requirement). In addition, the commercial paper must satisfy regulatory standards established by the SEC in connection with the Section 3(a)(3) exemption.

(A) *Nine-Month Requirement*

In conjunction with the Nine-Month Requirement, the SEC has taken the position that the Section 3(a)(3) exemption is not available for commercial paper that is payable only on demand or that is sub-

38. 15 U.S.C. § 77c(a)(3) (1982). Although there is little, if any, direct authority on point, it appears that short-term certificates of deposit, to the extent they are securities for purposes of the Securities Act, should qualify for an exemption under Section 3(a)(3), provided they satisfy all the relevant conditions of the exemption. Informal discussions with the SEC staff in the past suggest that the staff is unlikely to raise objections to this approach. For a discussion of the status of short-term certificates of deposit as securities under the Exchange Act, see *infra* note 161.

39. A guarantee by a foreign bank of its subsidiary's Section 3(a)(3) commercial paper will also be exempt under Section 3(a)(3) of the Securities Act provided the commercial paper meets the required tests for exemption under Section 3(a)(3). *See infra* note 261. In addition, in one anomalous no-action letter, the SEC staff granted a no-action position under Section 3(a)(3) to a foreign bank with no branches or agencies in the United States that proposed to issue irrevocable letters of credit in support of exempt commercial paper issued by the bank's United States customers, provided the bank complied with certain restrictions imposed by the SEC staff, such as limiting the amount of the offering, appointing an agent for service of process, and furnishing investors an offering circular containing business and financial information about the issuing foreign bank. Amsterdam-Rotterdam Bank N.V., SEC No-Action Letter [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,713, at 76,961 (available Oct. 14, 1980). Since the SEC staff based its determination on policy considerations, however, without necessarily agreeing with the legal analysis presented in the request letter, it is not clear what precedential value, if any, this no-action letter may have.

ject to "automatic rollover" at the option of either the issuer or the holder of the note.[40] In a recent no-action letter,[41] the SEC staff appears to have extended this rationale to automatic rollover provisions between a commercial paper issuer and its underwriter, even though the subsequent holders of the commercial paper notes would not have been involved in the rollover arrangement.[42]

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40. SEC Securities Act Release No. 4412 (Sept. 20, 1961), 26 Fed. Reg. 9158 (1961), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2045, at 2571 [hereinafter cited as Securities Act Release No. 4412]. Commercial paper is "rolled over" when the proceeds of a commercial paper note are reinvested by the holder upon the maturity of the note in a new note. Commercial paper is "automatically" rolled over when the proceeds of a note are reinvested immediately upon the maturity of the note without either the issuer or the holder of the note having to take any action.

The SEC has taken its position with respect to rollovers presumably because a note payable on demand would not necessarily have to be paid off within the nine month period required under the statute and a note subject to automatic rollover could operate in effect as an instrument with a maturity in excess of nine months.

41. A no-action letter is a response by the staff of a division of the SEC to a request by a party for an indication by the staff as to whether or not the staff would recommend that the SEC take enforcement action if the party engaged in the transaction specified in the party's request. No-action letters do not represent statements of the staff's or the SEC's legal opinion on the matters of law raised in the request and would not as a matter of law bind either the SEC or private litigants from bringing legal action in connection with the transaction in question. However, as a practical matter, the SEC's previously-articulated enforcement position with respect to a transaction would likely be given considerable weight by a court in determining the merits of securities law questions raised in connection with the transaction. In addition, since case law is rare with respect to many of the issues involved, the SEC's no-action position is of substantial guidance to issuers and their counsel considering engaging in the transactions in question.

42. In A.G. Becker Paribas Inc., SEC No-Action Letter (available July 2, 1984, on LEXIS, Fedsec library, Noact file), a commercial paper dealer (Becker) proposed to establish a Section 3(a)(3)—exempt commercial paper program involving two series of commercial paper notes issued by the same issuer. The second series of notes would have the same interest or discount rates as the first series of notes, but apparently could have been issued in smaller denominations and with shorter maturities than the first series of notes. At the option of the commercial paper issuer, Becker would have been required as dealer to purchase the second series of notes upon maturity of the first series. Since the persons to whom Becker sold the first series of notes would have had no obligation to purchase any of the second series notes, the ultimate purchasers of each series of notes would not necessarily have been the same parties. The SEC, stating without further explanation that "the delayed delivery arrangement would have the effect of allowing the issuer to extend the maturity of the initial notes," declined to respond favorably to Becker's request for a no-action position.

The Becker rollover mechanism can be distinguished from automatic rollover provisions that more clearly violate the spirit of the Nine-Month Requirement, such as those that involve a reinvestment of the same principal amount of funds by the same commercial paper holder in new commercial paper of the same issuer. The proposed rollover arrangement in the Becker program involved the issuer and Becker, as underwriter, but not the ultimate purchasers to whom Becker would sell the issuer's commercial paper notes.

The effect of the SEC staff's position in the Becker letter appears to be to preclude a commercial paper underwriter from committing to underwrite future issuances of an issuer's commercial paper upon the expiration of a first issuance if the interest or discount rates on subse-

(B) *Current Transactions Requirement*

Although the phrase "current transactions" is not defined in the Securities Act, SEC releases[43] and no-action letter authority have identified a variety of banking activities that qualify as current transactions for purposes of Section 3(a)(3). These activities include the use of proceeds for funding various commercial and consumer purposes,[44] for funding the operational needs of an issuer or its affiliates,[45] and for purchasing participations in loans.[46] In general, if a

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quent issuances are identical to those of earlier issuances. While this position may advance the objective of preventing a Section 3(a)(3) issuer from being able to rely on the availability of funds generated by the sale of commercial paper at interest rate levels that will remain constant for a period in excess of of nine months, it is difficult to see what policy objectives of the exemption are served by the position, since the issuer must in any case invest the proceeds in "current transactions" designed directly or indirectly to insure that the notes are self-liquidating. In addition, the position leaves something to be desired from an analytical standpoint, since the analogy between the series of notes involved in the Becker program (which could involve different holders, different denominations and different terms) and notes that are automatically rolled over by the issuer and the same holder is not compelling.

43. Letter of General Counsel Discussing the Availability of an Exemption from Registration to Collateral Trust Notes, Securities Act Release No. 401 (June 18, 1935), 11 Fed. Reg. 10,953 (1935), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2041, at 2570; Securities Act Release No. 4412, *supra* note 40.

44. Among the types of loans or other extensions of credit whose funding the SEC staff has approved with regularity in Section 3(a)(3) no-action correspondence are the following: consumer loans; loans for credit card receivables and over-draft protection; standing mortgage loans; pre-construction loans; construction mortgage loans; mortgage warehousing loans; commercial loans with maturities not exceeding five years; "factoring" (the purchasing of accounts receivable and similar obligations from manufacturers and dealers); equipment financing; "floor plan" loans (loans to dealers to finance inventories of consumer goods held for sale); the financing of equipment through installment sales; the purchase or carrying out of retail installment contracts relating to consumer items such as household furnishings, motor vehicles or boats; loans to foreign borrowers; loans to securities brokers or dealers; working capital loans; capital goods financing; oil and gas related loans; financing the short-term portions of long-term loans; and temporary or "bridge" loans. *See, e.g.*, U.S. Bancorp., SEC No-Action Letter (available Dec. 17, 1982, on LEXIS, Fedsec library, Noact file); Southern Nat'l Corp., SEC No-Action Letter (available Nov. 19, 1982, on LEXIS, Fedsec library, Noact file); Crocker Nat'l Corp., SEC No-Action Letter (available Nov. 15, 1982, on LEXIS, Fedsec library, Noact file).

45. Among the types of operational needs the funding of which the SEC has approved in Section 3(a)(3) no-action correspondence are: the payment of taxes; the payment of current operational expenses; and the payment of outstanding commercial paper or other short-term indebtedness. *See, e.g.*, U.S. Bancorp., SEC No-Action Letter (available Dec. 17, 1982, on LEXIS, Fedsec library, Noact file); Southern Nat'l Corp., SEC No-Action Letter (available Nov. 19, 1982, on LEXIS, Fedsec library, Noact file); Crocker Nat'l Corp., SEC No-Action Letter (available Nov. 15, 1982, on LEXIS, Fedsec library, Noact file).

46. Numerous favorable no-action letters have been issued in which commercial paper issuers have purchased participations in extensions of credit by affiliated lenders. *See, e.g.*, Liberty Nat'l Corp., SEC No-Action Letter (available May 6, 1983, on LEXIS, Fedsec library, Noact file). In each case, the extensions of credit in which participations were to be purchased themselves constituted current transactions under Section 3(a)(3).

commercial paper issuance is used to fund assets that are easily convertible into cash or could be compared to liquid inventories of an industrial or mercantile company, the SEC will usually consider the Current Transaction Requirement to be met.[47]

The SEC also has established a number of limitations on permissible uses of commercial paper proceeds. First, although the SEC staff occasionally has acquiesced in the use of commercial paper proceeds to fund extensions of credit with terms of more than five years,[48] recent no-action letter authority suggests that, absent special circumstances, the use of commercial paper proceeds to fund loans with a term of more than five years is inconsistent with the Section 3(a)(3) Current Transactions Requirement.[49] Second, subject to the exceptions discussed below, the SEC generally has not permitted commercial paper proceeds to be used to make investments in either real estate or securities.[50]

With respect to real estate, the SEC staff has acquiesced in the use of commercial paper proceeds to finance certain limited activities closely related to real estate. These uses include financing preconstruction loans (loans to finance the acquisition of land or the making of improvements to a site before construction begins), construc-

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A recent letter, Biltmore Holdings, Inc., SEC No-Action Letter (available Aug. 9, 1984, on LEXIS, Fedsec library, Noact file) [hereinafter cited as Biltmore], suggests the SEC staff may be relaxing the Current Transactions Requirement with respect to loan participations. In Biltmore, an issuer of commercial paper proposed to purchase participations in 95-day loans without specifying the purposes for which the proceeds of those loans would be used by the borrower. While the 95-day term would seem to ensure both that the loans would be relatively liquid and would not likely be used for long-term ventures, the fact that the SEC staff did not require a description of the uses to be made of the loan proceeds raises the possibility that an issuer could fund non-current transactions simply by structuring the participated loans as short-term instruments. It is unclear whether the SEC staff had this possibility in mind when it issued Biltmore. If so, the letter would represent an expansion of the SEC staff's past policy, in determining whether the Current Transactions Requirement was being met, of permitting commercial paper proceeds ultimately to be advanced in certain circumstances to parties who were not required to use the funds for current transactions. For example, the SEC has in a number of instances permitted bank holding companies to advance commercial paper proceeds to bank subsidiaries which in turn advanced the funds to customers for unspecified uses pursuant to commercial loans with maturities of five years or less. *See, e.g.*, Interstate Financial Corp., SEC No-Action Letter (available Oct. 11, 1983, on LEXIS, Fedsec library, Noact file).

47. *See* Securities Act Release No. 4412, *supra* note 40.

48. *See, e.g.*, National Detroit Corp., SEC No-Action Letter (available Jan. 15, 1979, on LEXIS, Fedsec library, Noact file) (funding of commercial paper to finance loans for working capital and operating expenses and to purchase commercial notes receivable, with terms "occasionally" extending to seven years, permitted).

49. *See, e.g.*, Western Nat'l Bancorp., Inc., SEC No-Action Letter (available Dec. 1, 1983, on LEXIS, Fedsec library, Noact file); Florida Coast Banks, Inc., SEC No-Action Letter (available Sept. 12, 1983, on LEXIS, Fedsec library, Noact file).

50. *See, e.g.*, Securities Act Release No. 4412, *supra* note 40.

tion loans (loans for the construction of buildings, plants and other relatively permanent structures) and post-construction financing during a so called "lease-up" phase (a period when a developer attempts to procure a substantial proportion of tenants for a property), provided the commercial paper financing is to be replaced by permanent financing within a limited period of time (*e.g.*, one year for pre-construction loans and five years or less for construction loans).[51] The SEC staff also has permitted commercial paper proceeds to be used to fund standing mortgage loans (loans to facilitate the purchase of existing structures) on an interim basis and to fund mortgage warehousing loans (loans to enable an investor to purchase and carry a portfolio of mortgages pending their resale to third parties).[52]

With respect to the use of commercial paper proceeds to acquire securities, the SEC staff has acquiesced in the use of proceeds to fund so-called "position" or "overnight" loans, with maturities not exceeding several days,[53] to securities brokers and dealers for the purpose of purchasing and selling securities. The rationale for this position appears to be a recognition of the fact that, in this instance, the securities constitute, in effect, inventory items rather than investments. In addition, apparently on the basis of the liquidity of the instruments involved, the SEC staff has permitted commercial paper proceeds to be used to fund purchases of money market obligations, such as United States government obligations, certificates of deposit, bankers' acceptances, commercial paper and other short-term obligations both when the funding of such uses was incidental to other recognized current transaction uses[54] and when the funding of such uses appears to have been the primary focus of the commercial paper

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51. *See, e.g.*, Florida Coast Banks, Inc., SEC No-Action Letter (available Sept. 12, 1983, on LEXIS, Fedsec library, Noact file); Olympia & York Properties, SEC No-Action Letter (available Oct. 29, 1984, on LEXIS, Fedsec library, Noact file). In these instances, it appears that the activities being financed may be viewed as analogous to turning raw materials into finished inventory, a typical Section 3(a)(3) use of proceeds.

52. *See, e.g.*, Western Nat'l Bancorp., SEC No-Action Letter (available Dec. 21, 1983, on LEXIS, Fedsec library, Noact file); Citizens and Southern Georgia Corp., SEC No-Action Letter (available Jan. 7, 1983, on LEXIS, Fedsec library, Noact file) (mortgage warehousing loans). In these instances, the SEC staff appears to view the interests in the real property being financed as similar to "inventory." *See* Harrington, *Use of the Proceeds of Commercial Paper Issued by Bank Holding Companies*, 29 BUS. LAW. 207, 220-21 (1973) [hereinafter cited as Harrington].

53. *See, e.g.*, Florida Coast Banks, Inc., SEC No-Action Letter (available Sept. 12, 1983, on LEXIS, Fedsec library, Noact file) (normal term of one to four days); Crocker Nat'l Corp., SEC No-Action Letter (available Nov. 15, 1982, on LEXIS, Fedsec library, Noact file) (normal term of one to fourteen days).

54. *See, e.g.*, Liberty Nat'l Corp., SEC No-Action Letter (available May 6, 1983, on LEXIS, Fedsec library, Noact file).

program.[55] The SEC staff currently does not permit commercial paper proceeds to be used to acquire securities for purposes of business acquisitions.[56]

Despite the general requirements that commercial paper proceeds be used for current transactions, in recent years the SEC staff has not required that issuers of commercial paper "trace" the proceeds from commercial paper issuances to ensure that the proceeds are actually used for current transactions. While this position does not authorize an issuer to use commercial paper proceeds for proscribed purposes, if an issuer has current transaction funding requirements equal to or greater than the proceeds from its outstanding commercial paper issuances, the staff's position permits a commercial paper issuer to commingle its commercial paper proceeds with other funds without having to demonstrate that the funds generated by a specific

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55. *See* Kellogg Co., SEC No-Action Letter (available Oct. 7, 1983, on LEXIS, Fedsec library, Noact file), in which the SEC staff raised no objection to an issuer's commercial paper program in which apparently the primary proposed use of the proceeds was to invest in a variety of obligations, including United States government obligations, municipal obligations, commercial bank obligations, commercial paper and other short-term debt instruments, without any proposed use of the proceeds subsequently for operational or non-investment activities. *But cf.* Gillette Co., SEC No-Action Letter (available May 15, 1984, on LEXIS, Fedsec library, Noact file), in which an issuer of commercial paper proposed to use the proceeds thereof to, among other things, invest in the equity shares of diversified, open-end investment companies which themselves invested only in United States dollar denominated money market instruments, all of which would mature in one year or less from the date of purchase. Despite the fact that under existing no-action letter authority the issuer could have invested directly in each of the obligations in which the investment companies would invest, the SEC staff refused to take a no-action position regarding the proposed use of proceeds because it involved an investment in equity securities. *Cf. also* Pan American Banks, Inc., SEC No-Action Letter (available May 28, 1984, on LEXIS, Fedsec library, Noact file), in which it appears that the staff of the SEC, as a condition to granting an issuer's request for a no-action position, required the issuer to revise its proposed use of commercial paper proceeds to exclude investment in arbitrage transactions involving securities, even though the securities all had short-term maturities.

56. For a short period, the SEC staff raised no objection to the use of commercial paper proceeds by bank holding companies for interim or "bridge" financing of business acquisitions, including acquisitions effected through stock purchases. *See, e.g.*, Hartford Nat'l Corp., SEC No-Action Letter (available Oct. 30, 1981, on LEXIS, Fedsec library, Noact file); Mercantile Bancorp., Inc., SEC No-Action Letter (available Oct. 15, 1980, on LEXIS, Fedsec library, Noact file). Beginning in the summer of 1982, however, the SEC staff reversed itself and declined to take no-action positions with respect to commercial paper proceeds used to provide interim financing for acquisitions. *See, e.g.*, Valley Nat'l Corp., SEC No-Action Letter (available June 14, 1982, on LEXIS, Fedsec library, Noact file); First Commerce Corp., SEC No-Action Letter (available Apr. 26, 1982, on LEXIS, Fedsec library, Noact file). This approach, which differs from the staff's treatment of interim financing for real estate construction loans, emphasizes the staff's continuing sensitivity to the use of commercial paper proceeds to fund investments in securities.

commercial paper offering are being directly applied to current transactions.[57]

(C) *Additional Regulatory Standards*

In addition to the explicit statutory requirements of Section 3(a)(3) of the Securities Act, it is the SEC's position that Congress intended the exemption to apply only to "prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well-recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks."[58]

The term prime quality is not defined either in the Securities Act or in the SEC's rules. It seems clear from the SEC staff's no-action letters, however, that commercial paper is of "prime quality" if it is highly rated by one or more recognized rating services.[59] Although it is possible that commercial paper may be considered prime quality even if it is not rated,[60] the commercial paper of a financially troubled issuer or of an issuer without an established history of operations clearly will not be considered prime quality.[61]

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57. *See, e.g.*, Ameritrust Corp., SEC No-Action Letter (available Aug. 6, 1984, on LEXIS, Fedsec library, Noact file); United Jersey Banks, SEC No-Action Letter (available July 16, 1984, on LEXIS, Fedsec library, Noact file).

58. Securities Act Release No. 4412, *supra* note 40. These standards also have been recognized by the courts. *See, e.g.*, Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

59. *See, e.g.*, Meridian Bancorp. Inc./Meridian Funding Corp., SEC No-Action Letter (available Sept. 21, 1984, on LEXIS, Fedsec library, Noact file) (notes to be issued pursuant to Section 3(a)(3) would receive highest investment grade rating of at least one nationally recognized rating agency); Texaco Inc., SEC No-Action Letter (available Sept. 21, 1984, on LEXIS, Fedsec library, Noact file) (notes to be issued pursuant to Section 3(a)(3) would receive highest ratings by Standard & Poor's Corporation and Moody's Investors Service, Inc.); Shearson American Express Holdings, Inc., SEC No-Action Letter (available June 11, 1984, on LEXIS, Fedsec library, Noact file); Redland Finance, Inc., SEC No-Action Letter (available Jan. 23, 1984, on LEXIS, Fedsec library, Noact file); Zale Corp., SEC No-Action Letter (available Oct. 28, 1983, on LEXIS, Fedsec library, Noact file).

60. *See, e.g.*, NS&T Bankshares, Inc., SEC No-Action Letter (available Aug. 16, 1984, on LEXIS, Fedsec library, Noact file); Deposit Guaranty Corp., SEC No-Action Letter (available Nov. 7, 1977, on LEXIS, Fedsec library, Noact file). *See also* Bakco Acceptance, Inc., SEC No-Action Letter (available Oct. 18, 1976, on LEXIS, Fedsec library, Noact file), in which the SEC staff suggests that notes of a quality eligible to be discounted at a Federal Reserve bank would be considered prime quality.

61. *See, e.g.*, Bakco Acceptance, Inc., SEC No-Action Letter (available Oct. 18, 1976, on LEXIS, Fedsec library, Noact file); Real-Tex Enterprises, Inc., SEC No-Action Letter (available May 15, 1972, on LEXIS, Fedsec library, Noact file). *See also* Gruson & Jackson, *Issuance of Securities by Foreign Banks and the Investment Company Act of 1940*, 1980 U. ILL. L.F. 185, 191-92 [hereinafter cited as Gruson & Jackson]; Hicks, *Commercial Paper: An Ex-*

The SEC staff has relied on two principal limitations designed to ensure that commercial paper is of a type not ordinarily purchased by the general public: (i) a limitation on the minimum denomination of the commercial paper; and (ii) a limitation on the manner in which the commercial paper is offered for sale.

The minimum denomination limitation appears to be intended to keep small, presumably less sophisticated, purchasers out of the market. The SEC staff has routinely granted no-action letters for commercial paper programs involving minimum denominations of $100,000 or more, the amounts typically found in the commercial paper market.[62] Although the SEC staff, in the past, has granted no-action letters involving commercial paper with a minimum denomination of as low as $10,000,[63] more recent no-action letters have not involved minimum denominations of less than $25,000.[64]

Restrictions on the manner in which commercial paper must be offered function as an additional means of ensuring that commercial paper is of a type not ordinarily purchased by the general public. In this regard, the SEC's no-action letters suggest that commercial paper may not be offered (i) by means of advertising to the general public or (ii) to unsophisticated offerees.[65] To comply with the foregoing limitation, underwriters generally offer commercial paper only to a prescreened group of institutional and sophisticated individual investors who are furnished abbreviated descriptive and financial information about the issuer of the commercial paper.[66]

The SEC's requirement that commercial paper issued in reliance on the Section 3(a)(3) exemption be of a type eligible for discount

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empted Security Under Section 3(a)(3) of the Securities Act of 1933, 24 UCLA L. REV. 227, 237-39, 242-43 (1976).

62. *See, e.g.*, Pan American Banks, Inc., SEC No-Action Letter (available May 28, 1984, on LEXIS, Fedsec library, Noact file).

63. *See, e.g.*, Allied Bancshares, SEC No-Action Letter (available Dec. 14, 1978, on LEXIS, Fedsec library, Noact file). *But cf.* Central Fidelity Banks, Inc., SEC No-Action Letter (available June 29, 1981, on LEXIS, Fedsec library, Noact file), in which the SEC staff contested the availability of the Section 3(a)(3) exemption in light of a $10,000 minimum denomination.

64. *See, e.g.*, Hartford Nat'l Corp., SEC No-Action Letter (available Mar. 29, 1984, on LEXIS, Fedsec library, Noact file); Western Nat'l Bancorp., Inc., SEC No-Action Letter (available Dec. 1, 1983, on LEXIS, Fedsec library, Noact file).

65. *See, e.g.*, Balcor/American Express Real Estate Fin., Inc., SEC No-Action Letter (available Mar. 27, 1984, on LEXIS, Fedsec library, Noact file).

66. Although certain of the restrictions on the manner of offering commercial paper pursuant to Section 3(a)(3) of the Securities Act are similar to those imposed on private placement offerings under Section 4(2) of the Securities Act, the SEC has not suggested that purchasers of exempt commercial paper must have access to the same degree of information required to be disclosed in a private placement. *See infra* notes 89-99 and accompanying text.

by a Federal Reserve bank apparently was intended originally to ensure that commercial paper be of a certain quality and that it arise out of current transactions as required by Section 3(a)(3). As in effect in 1933, when Section 3(a)(3) was enacted, the standards used by Federal Reserve banks for discounting notes reflected an intention on the part of the Board of Governors of the Federal Reserve System (Board or Federal Reserve Board) to limit the banks' discounting function to short-term, self-liquidating commercial paper meeting specific eligibility requirements.[67] These standards have been greatly liberalized since 1933, however, and appear to have lost most, if not all, of their force as a practical standard for determining the type of commercial paper intended to be exempt under Section 3(a)(3).[68]

iv. *Exemption for Bank-Guaranteed Securities*

An offering of securities by a foreign bank, which is not made through the foreign bank's United States branch or agency, also may be exempt from the registration requirements of the Securities Act if the securities are guaranteed by a United States bank. Section 3(a)(2) of the Securities Act provides an exemption for securities issued or guaranteed by, among other entities, any national bank or state-chartered banking institution engaged in business "which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official. . . ."[69] The "bank guarantee" portion of Section 3(a)(2) has been widely utilized to exempt from registration securities not otherwise exempt from registra-

67. *See* Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362, 390 (1972) [hereinafter cited as *The Commercial Paper Market*].

68. *Id.* at 389-92. Under the Board's current standards for discounting, established in 1980, a Federal Reserve bank is authorized to discount "notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes. . . ." 12 U.S.C. § 343 (1982). Thus, under current law, the Board's eligibility requirements do not require that commercial paper eligible for discount be used for current transactions or be self-liquidating. *Id.* Under such a standard, virtually any business use of commercial paper proceeds by an issuer would appear to be eligible for discount by the Federal Reserve banks.

The statute also requires that, in order to be eligible for discount, commercial paper must have a period remaining to maturity of not more than 90 days. The SEC staff has taken the position, however, that the exemption provided by Section 3(a)(3) of the Securities Act will be available irrespective of this 90 day requirement. *See* Daniel E. Stoller, SEC No-Action Letter, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,704, at 86,827 (available Aug. 27, 1976).

69. 15 U.S.C. § 77c(a)(2) (1982).

tion in instances where a national or state bank's guarantee supports such securities.

Section 3(a)(2), by its express terms, does not include banks organized under the laws of a foreign country. As a result, the Section 3(a)(2) exemption generally is not available for securities issued or guaranteed by a foreign bank where the foreign bank does not issue or guarantee such securities through its United States branch or agency.[70]

A foreign bank could, however, utilize the exemption provided by Section 3(a)(2) if its securities were guaranteed by a national bank or state-chartered banking institution in the United States. In addition, as discussed below, a guarantee by a United States branch or agency of the foreign bank might similarly enable the foreign bank to rely on the Section 3(a)(2) exemption for bank-guaranteed securities.[71]

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70. Securities issued or guaranteed by a United States branch or agency of a foreign bank may qualify for an exemption under Section 3(a)(2) of the Securities Act. *See infra* notes 351-64 and accompanying text. In addition, some early no-action letters by the SEC staff raise the possibility that a foreign bank itself could issue securities in reliance on the Section 3(a)(2) exemption if it had banking operations in the United States that were subject to adequate supervision and regulation by state banking authorities. *See, e.g.*, Bank Leumi le-Israel B.M., SEC No-Action Letter (available Apr. 9, 1979, on LEXIS, Fedsec library, Noact file). Although the staff's response letters speak in terms of securities being issued by the foreign banks, the facts in the incoming request letters reveal that the securities were being issued by a United States branch or agency of the foreign bank. *See, e.g., id.* More recent no-action letters in this area have related only to the branches and agencies of foreign banks.

In addition, it appears that, under certain circumstances, a foreign bank's guarantee may qualify for the same exemption from registration as the securities supported by the guarantee. The SEC staff has informally indicated that it might be willing to grant no-action relief under Section 3(a)(2) if a foreign bank issued letters of credit or guarantees in support of industrial revenue bonds (which are themselves independently exempt from registration pursuant to a separate provisions in Section 3(a)(2)), provided the foreign bank essentially had an equity interest in the project or facility constructed with the proceeds of the issuance of the industrial revenue bonds. This informal advice was based on certain no-action responses which concluded that guarantees in support of industrial revenue bonds could be issued without registration under Section 3(a)(2) by an entity which would derive substantial economic benefit from the project. *See* Toledo-Lucas County Port. Auth. (Mid-States Terminals, Inc.), SEC No-Action Letter (available July 19, 1978, on LEXIS, Fedsec library, Noact file). *See also infra* note 261 (concerning a foreign bank's guarantee of its subsidiary's commercial paper).

71. Neither the Securities Act nor the SEC's regulations promulgated thereunder provide any elaboration as to what types of instruments are encompassed by the term "guarantee" for purposes of the Securities Act. To the extent that a foreign bank's securities are supported by an actual guarantee issued by a bank, the securities would clearly appear to be guaranteed by a bank within the meaning of Section 3(a)(2). In addition, the SEC generally has viewed irrevocable letters of credit issued in support of debt securities to be equivalent to guarantees, provided the letters of credit cover the full amount of principal and interest payable pursuant to the debt securities. *See, e.g.*, CRA (Argyle) Finance Ltd., SEC No-Action Letter (available Sept. 17, 1984, on LEXIS, Fedsec library, Noact file); Lomas & Nettleton Mortgage Inves-

v. *The Private Placement Exemption*

Section 4(2) of the Securities Act exempts from the registration requirements of Section 5 of the Securities Act "transactions by an issuer not involving any public offering."[72] Unlike the exemptions for specific types of securities discussed above, the exemption afforded by Section 4(2), commonly known as the private placement exemption, is based not on the type of security being offered but on the transaction in which the security is being sold. As a result, a foreign bank issuer could utilize the Section 4(2) exemption for any debt or equity securities for which no other exemption from registration was available.

A foreign bank issuer intending to rely on the private placement exemption will find little guidance in the Securities Act regarding the appropriate means of effecting an offering of securities in compliance with that exemption. The term "public offering" is not defined in the Securities Act, and the determination of whether a particular offering qualifies for the statutory private placement exemption cannot be made without reference to judicial and administrative interpretations of that exemption.

To alleviate some of the difficulties inherent in ensuring that an offering complies with Section 4(2), Rule 506 of the SEC's Regulation D provides that an offering by an issuer effected in accordance with all of the provisions of that rule shall be deemed to be a transaction "not involving any public offering within the meaning of Section 4(2). . ."[73] The availability of the exemption afforded by Rule 506 can be determined with considerable precision by reference to the specific requirements of the rule.[74]

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tors, SEC No-Action Letter [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,543, at 81,174 (available Dec. 1, 1971).

72. 15 U.S.C. § 77d(2) (1982). The term "issuer" is defined in Section 2(4) of the Securities Act as "every person who issues or proposes to issue any security. . ." 15 U.S.C. § 77b(4) (1982).

73. 17 C.F.R. § 230.506(a) (1985). *See generally* SEC Securities Act Release No. 6455, 48 Fed. Reg. (1983), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2380, at 2637 (Mar. 3, 1983) [hereinafter cited as Regulation D Interpretive Release].

74. The exemptions from the registration provisions of the Securities Act provided by Section 4(2) and Rule 506 co-exist as alternative means by which an issuer can make a non-public offering. Although the Section 4(2) exemption is not directly modified by Rule 506, it is generally assumed that an offering effected in compliance with all of the provisions of Rule 506 (which, in turn, references Rules 501 to 503) will also qualify for the statutory private placement exemption. In addition, an offering which, due to non-compliance with one or more provisions of Rule 506, fails to qualify for the exemption afforded by that rule, may nonetheless be exempt pursuant to Section 4(2).

(A) *Section 4(2) of the Securities Act*

In the 1953 landmark decision, *SEC v. Ralston Purina Co.*,[75] the United States Supreme Court established the basic criteria for determining whether a particular offering qualifies for the statutory private placement exemption. In *Ralston Purina*, the Court reasoned that the applicability of the statutory private placement exemption to a particular offering "should turn on whether the particular class of persons affected need the protection of the [Securities] Act" and that an "offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.' "[76] The Court held that an offering to a group of employees, who were not in a position to have access to the same kind of information made available in a registration statement under the Securities Act, required the protections of registration. The principal factors to be considered in analyzing whether, under *Ralston Purina* and subsequent cases, the statutory private placement exemption is available for a particular offering are discussed below.[77]

Nature and Number of Offerees. Ralston Purina and subsequent judicial interpretations of Section 4(2) have established a two-prong test for determining the nature of offerees who are deemed not to need the protections of Securities Act registration and to whom a private placement may, therefore, be made. Both of the tests must be met before the Section 4(2) exemption is available.

Under the first prong of the test, all offerees in a private placement must be able to fend for themselves in the sense that they are sufficiently sophisticated to demand and understand information relevant to the offering. The courts have tended to examine a combination of factors as indicative of the degree of sophistication of an investor such as education, occupation, business experience, prior investment experience, relationship with other offerees, relationship to the issuer, net worth, and sophistication of the investor's advisers.[78] Most institutional investors, such as insurance companies, pro-

75. 346 U.S. 119 (1953).

76. *Id.* at 125.

77. The SEC has confirmed that: "Whether a transaction is one not involving any public offering is essentially a question of fact and necessitates a consideration of all surrounding circumstances, including such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering." Securities Act Release No. 4552 (Nov. 6, 1962), 27 Fed. Reg. 11,316, *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2770-2783, at 2918 (1962) [hereinafter cited as SEC Securities Act Release No. 4552].

78. *See, e.g.*, Doran v. Petroleum Management Corp., 545 F.2d 893, 902 (5th Cir. 1977) (net worth: purchaser had net worth in excess of $1 million); Klapmeier v. Telecheck Int'l, Inc., 482 F.2d 247, 254 (8th Cir. 1973) (sophistication of adviser: offeree's adviser was presi-

fessionally-managed pension plans, and investment companies, should possess the requisite sophistication to be considered eligible offerees in a private placement.

Under the second prong of the test, all offerees must have available to them the type of information that would be disclosed in a Securities Act registration statement. *Ralston Purina* articulated this test as requiring that each offeree be in a position to have access to the requisite information.[79] Courts generally have interpreted this standard as requiring that each offeree have a sufficiently close relationship with the issuer (or the issuer's agents) to afford the offeree the opportunity to acquire information about the issuer that the offeree needs to make an informed investment decision.[80]

Some courts appear to have interpreted *Ralston Purina* to suggest that the Section 4(2) exemption is available only if offerees in the private placement offering enjoy a privileged relationship with the issuer.[81] The more recent view, however, is that the relationship between an issuer and the offerees is significant only if the offeree has not actually received full disclosure of all the information required in a registration statement.[82] In other words, to be considered an eligible offeree in a private placement, the offeree must be shown either

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dent and principal stock-holder of the acquired company and had access to information registration would disclose); Barrett v. Triangle Mining Corp., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,438, at 99,211 (S.D.N.Y. 1976) (education, business experience: one plaintiff had attended Harvard College and the other plaintiff had received an M.B.A. in finance; both plaintiffs had many years experience as executive officers of a manufacturing company); Livens v. William D. Witter, Inc., 374 F. Supp. 1104, 1109 (D. Mass. 1974) (occupation, investment experience: plaintiff had five years experience as an investment analyst); Bowers v. Columbia Gen. Corp., 336 F. Supp. 609, 622-23 (D. Del. 1971) (relationship to issuer and other offerees: issuer and offerees in comparable businesses, all offerees related by family ties and as stockholders of the corporation being sold to the issuer).

79. 346 U.S. at 125.

80. SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972). *See also* Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 688 n.6 (5th Cir. 1971) ("a class of persons having such a privileged relationship with the issuer that their present knowledge and facilities for acquiring information about the issuer would make registration unnecessary for their protection. . . .").

Persons often identified as having the type of special relationship that negates the need for protection of Securities Act registration include insiders, such as executive personnel, relatives and close friends, and business associates or others with sufficient economic bargaining power to obtain requisite information from the issuer. For example, the Court of Appeals for the Fifth Circuit has defined offerees in a position to have access to information to include offerees: "who are in a position relative to the issuer to obtain the information registration would provide. . . . By a position of access we mean a relationship based on factors such as employment, family or economic bargaining power that enables the offeree effectively to obtain such information." SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).

81. *See, e.g., Continental Tobacco Co.*, 463 F.2d at 137.

82. *See, e.g.*, Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977).

(i) to have actual knowledge of all requisite information or (ii) to have a relationship with the issuer designed to give the offeree access to all requisite information.

Ralston Purina established that the nature of offerees in a private placement, as determined according to the above tests, is more significant than the number of offerees in analyzing whether the Section 4(2) exemption is available. Although, prior to the Supreme Court's decision in *Ralston Purina*, it was generally assumed that an offering to not more than twenty-five people did not involve a public offering,[83] the Court in *Ralston Purina* concluded that the number of offerees is not dispositive of the availability of the statutory private placement exemption.[84] Both the SEC and the courts have reaffirmed this position.[85]

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83. *See* Securities Act Release No. 285 (Jan. 24, 1935), 11 Fed. Reg. 10,952 (1935), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶¶ 2740-2744, at 2911.

84. 346 U.S. at 125 (1953).

85. *See* Securities Act Release No. 4552, *supra* note 77 ("The number of persons to whom the offering is extended is relevant only to the question whether they have the requisite association with and knowledge of the issuer to make the exemption available."); Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959), *aff'g In re* Gilligan, Will & Co., 38 S.E.C. 388 (1958), *cert. denied*, 361 U.S. 896 (1960); Knapp v. Kinsey, 249 F.2d 797 (6th Cir.), *rev'g* Kinsey v. Knapp, 154 F. Supp. 263 (E.D. Mich. 1957), *cert. denied*, 356 U.S. 935 (1958).

As a result, a small number of offerees no longer ensures the availability of the private placement exemption. *In re* Mark E. O'Leary, SEC Exchange Act Release No. 8361, 43 S.E.C. 842 (July 25, 1968); *In re* Strathmore Securities, Inc., SEC Exchange Act Release No. 8207 (Dec. 13, 1967). Indeed, on at least one occasion, an offering to only one offeree has been held to be a public offering. *See* Parvin v. Davis Oil Co., 524 F.2d 112 (9th Cir. 1975), *cert. denied*, 445 U.S. 965 (1980). Conversely, offerings are frequently made to a relatively large number of institutional investors without destroying the private placement exemption.

The number of offerees while not a decisive factor, nevertheless, remains relevant in suggesting the existence or absence of a public offering. Courts have concluded that a large number of offerees tends to negate the availability of the Section 4(2) exemption and suggest that there may be some upper limit on the number of offerees that may be solicited in a private placement. *See, e.g.*, SEC v. Universal Major Industries Corp., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,229, at 98,212 (S.D.N.Y. 1975) ("where the transferees numbered in the hundreds, the sheer size of the distribution tends to negate the assumption that no public offering was involved"); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 688 (5th Cir. 1971) ("the more offerees, the more likelihood that the offering is public"); SEC v. Cal-Am Corp., 445 F. Supp. 1329 (C.D. Cal. 1978) (offering to 4000 investors not a private placement). *See also* Iowa Business Dev. Credit Corp., SEC No-Action Letter, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,480, at 81,032 (available Nov. 26, 1971) (The staff of the SEC refused to grant a no-action position with respect to whether an offering to 500 offerees required compliance with the registration provisions of the Securities Act, notwithstanding that the offerees were institutional or otherwise sophisticated investors which were provided with information comparable to the information contained in a registration statement.).

In addition, the number of offerees may be relevant in evaluating whether the offerees constitute a class of persons having a special relationship with one another or the issuer which permits them to be distinguished from the general public. *See, e.g.*, Hill York Corp. v. Ameri-

Manner of Offering. The manner of the offering is another factor the SEC and the courts generally consider relevant to the availability of the Section 4(2) private placement exemption.[86] Since a private placement offering may involve only eligible offerees, the offering must be made in a manner which permits the issuer, or its agents, to exercise control over the persons to whom offers are made. In practical terms, this control can be assured only through direct communication and negotiation by the issuer of the securities, or its agents, with eligible offerees.[87] Professional placement agents, such as investment bankers and brokers, may be used, provided they comply with all the restrictions of a private offering to which the issuer is subject. To ensure that offers are made only to eligible offerees and not to the general public, the offering of securities in a private placement may not involve any general advertising or general solicitation.[88]

Information Requirements. As discussed above, *Ralston Purina* established that reliance on the Section 4(2) private placement exemption requires that the offerees have available to them the kind of information that Securities Act registration would disclose.[89] This information includes disclosure about the securities and the offering transaction and about the issuer and its business, executive officers and directors, principal shareholders, and financial statements.[90]

If a foreign bank is subject to the continuous reporting requirements of the Exchange Act, the foreign bank generally should be

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can Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Securities Act Release No. 4552, *supra* note 77.

86. *See, e.g.*, SEC v. Murphy, 626 F.2d 633, 644 (9th Cir. 1980); Swenson v. Engelstad, 626 F.2d 421, 425 (5th Cir. 1980).

87. Rule 506, unlike the statutory private placement exemption, is concerned with the actual purchasers of the securities and not with the offerees. As a result, the rationale underlying the limitations in the manner of effecting an offering under Section 4(2) is inapplicable in a Rule 506 offering. *See infra* notes 102-09 and accompanying text.

88. Securities Act Release No. 4552, *supra* note 77. This prohibition of general advertising and general solicitation applies to media advertisements and announcements, as well as to random mailings and distributions of brochures and pamphlets. A foreign bank issuer intending to rely on the private placement exemption should, therefore, avoid "mass" distributions of offering materials and public sales efforts prior to, during, and for a reasonable period following, the private placement.

89. *Ralston Purina*, 346 U.S. at 127. As a result, the disclosure burden for an issuer is significantly greater in a private placement transaction than in an offering of securities made in reliance on the exemptions provided by Section 3(a)(2) or 3(a)(3) of the Securities Act.

90. Schedule A of the Securities Act sets forth 32 categories of information that must be set forth in a registration statement. 15 U.S.C. §§ 77aa 1-32 (1982). Generally, these are viewed as the type of information that must be made available in a private placement. See *infra* notes 398-403 and accompanying text for the disclosure requirements applicable to the registration statements of foreign private issuers.

able to satisfy these information requirements by making available the same kind of information as would be disclosed in its annual report on Form 20-F under the Exchange Act.[91] If a foreign bank is not a reporting company under the Exchange Act, it may still satisfy these information requirements by making available the same kind of information that would be disclosed by the foreign bank if it were reporting on Form 20-F; however, since the information would not be collected routinely for an annual report on Form 20-F, the requisite information may not be readily available. The bank's difficulty in obtaining, or its inability to obtain, the requisite information, however, does not relieve the bank of its responsibility to make the information available to offerees.[92]

On the other hand, the availability of the statutory private placement exemption does not necessitate the actual delivery by the issuer of all requisite information to offerees, provided the issuer can demonstrate that each offeree was in a position to have access to the requisite information.[93] As discussed above, whether an offeree is in a position to have access to the requisite information generally involves a determination that the offeree has a relationship with the issuer that affords the offeree the opportunity to obtain the requisite information.[94]

In light of the above requirements, a foreign bank issuer relying on the Section 4(2) exemption for a private placement offering generally should furnish each offeree a private placement memorandum or offering circular that includes a description of the offering and a general description of the bank including material financial information.[95] If the offering is made to any offerees that might not be in a

91. *See infra* notes 389-97 and accompanying text.

92. *See* Livens v. William D. Witter, Inc., 374 F. Supp. 1104, 1111 (D. Mass. 1974) ("the touchstone under § 4(2) is the offerees' need, not the issuer's. Companies unable to furnish significant financial information may be compelled to forego refinancing except by private lending institutions.").

93. *See, e.g.*, Neuwirth Inv. Fund, Ltd. v. Swanton, 422 F. Supp. 1187, 1197-98 (S.D.N.Y. 1975) (the court rejected plaintiffs' claim that defendants, a brokerage firm, did not provide them with accurate complete information concerning the issuer of the securities because plaintiffs, two foreign investment corporations, were in a position to obtain the information directly from the issuer); The Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,523, at 94,953 (S.D.N.Y. 1965) (the court rejected plaintiffs' claim that the issuer failed to provide them with the requisite information because (i) the plaintiffs' agent told the issuer that the plaintiffs already had the information and (ii) the plaintiffs were sophisticated enough and had adequate bargaining power to demand the requisite information); Exchange Act Release No. 8361 (July 25, 1968), *supra* note 85.

94. *See supra* note 85 and accompanying text.

95. Similar considerations arise under Regulation D when sales are made to persons who are not "accredited investors" under Rule 506. *See infra* notes 110-14 and accompanying text.

position to have access to all the information they need to make an investment decision, the disclosure document should include all the information required in a Securities Act registration, which would provide detailed information about the bank.[96] In certain offerings, such as an offering to all institutional investors, the document may contain more limited information.[97]

In any event, however, the voluntary disclosure of information to offerees, while strengthening the issuer's claim to the private placement exemption, will not by itself ensure the exemption's availability.[98] All other requirements of the private placement exemption also must be met.[99]

Size of the Offering and Number of Units. While the size of an offering and the number of units being offered have long been considered factors that indicate whether the Section 4(2) exemption is available,[100] they rarely are critical to a court's determination of whether an offering is public or private. As with the number of offerees, these factors have little to do with whether offerees need the protections of registration.[101]

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96. *See, e.g.*, Livens v. William D. Witter, Inc., 374 F. Supp. 1104 (D. Mass. 1974) (private placement claim upheld although offeree not provided with financial statements because offeree did not need the information and would not have relied on it to make investment decision).

97. A.B.A., SECTION 4(2) AND STATUTORY LAW, 31 BUS. LAW. 485, 496 (1975) (In certain circumstances, such as an offering only to institutional investors, "[i]t is probably adequate to give basic information concerning the issuers financial condition, results of operations, business, property and management.").

98. Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 688 (5th Cir. 1971) (quoting Loss, 4 Securities Regulations 2632 (2d ed. Supp. 1969)) ("'. . . this says too much if it implies that the exemption is assured, no matter what the circumstances, by giving each offeree the same information that would be contained in a registration statement though without the statutory safeguards and sanctions.' ").

99. *See, e.g.*, Doran v. Petroleum Management Corp., 545 F.2d at 905; *In re* John R. Brick, SEC Exchange Act Release No. 11,763 (available Oct. 24, 1975, on LEXIS, Fedsec library, SEC file).

100. *See, e.g.*, Securities Act Release No. 285, *supra* note 83.

101. Both the size of the offering and the number of units may be relevant, however, in suggesting the probability that an offering can be completed within the confines of the private placement exemption, particularly when the offering is made to individuals that are not affiliated with the issuer. Securities Act Release No. 4552, *supra* note 77. For example, although a large private offering to institutional and other sophisticated investors would not be precluded, the larger the offering and the number of units being offered, the more important it will be for an issuer to control both the persons to whom offers are made and the subsequent distribution of the securities, in order to prevent characterization of the offering as a public offering. For a discussion of restrictions on resales of securities acquired in a private placement, see *infra* notes 120-33 and accompanying text.

(B) *Rule 506 of Regulation D: The Safe-Harbor Rule*

In 1982, the SEC adopted Regulation D pursuant to Section 4(2) of the Securities Act.[102] Regulation D comprises six rules, designated Rules 501-506, which together replace a number of earlier SEC rules providing exemptions from registration under the Securities Act for transactions involving limited offers and sales of securities. Rule 506 was promulgated to provide a "safe harbor" for persons seeking to rely on the private placement exemption afforded by Section 4(2) of the Securities Act.[103]

Pursuant to Rule 506 of Regulation D, offers and sales of securities by an issuer that satisfy the conditions discussed below are deemed to be transactions not involving any public offering within the meaning of Section 4(2) of the Act.[104] Although failure to comply with any applicable provision of Rule 506 is likely to invalidate a claim to the exemption afforded by Rule 506, it is possible that the offering could, nonetheless, qualify for exemption under Section 4(2) if effected in a manner consistent with the Section 4(2) standards.

Nature and Number of Purchasers. Unlike the statutory private placement exemption under Section 4(2) of the Securities Act, Rule 506 imposes conditions on the nature and number of purchasers rather than on offerees. Consequently, the protections of Rule 506 are not lost if an offering is made to a non-qualifying offeree that, in fact, does not purchase securities in the offering.

Rule 506 distinguishes between "accredited investors" and other purchasers. The term "accredited investor" is defined by Rule 501(a) to include persons who come within any of the following categories, or who the issuer reasonably believes come within one or more of such categories, at the time of the sale of the securities to those persons: (i) certain categories of institutional investors; (ii) directors, executive officers or general partners of the issuer or of the issuer's general partner; (iii) any person who purchases at least $150,000 of the securities being offered, provided the purchase price does not exceed 20 percent of the purchaser's net worth and the

102. 17 C.F.R. § 230.501-506 (1985), *adopted in* SEC Securities Act Release No. 6389 (Mar. 8, 1982), 47 Fed. Reg. 11251 (1982), *reprinted in* [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,106, at 84,907.

103. Rules 501-503, which set forth definitions, general conditions to be met and notice requirements applicable to all offerings under Regulation D, are discussed herein only insofar as those provisions relate to Rule 506. Rules 504 and 505, which were promulgated pursuant to the small offering exemption of Section 3(b) of the Securities Act, are beyond the scope of this article.

104. 17 C.F.R. § 230.506(a) (1985).

purchase price is paid in cash or as otherwise specified; (iv) a natural person with a current net worth of $1 million or with an individual income of over $200,000 currently and for the past two years; and (v) any entity in which all the equity owners are accredited investors.[105]

With respect to non-accredited investors, Rule 506 requires that the issuer reasonably believe that such purchaser, either alone or with his purchaser representative, has sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the investment.[106] Accredited investors are presumed to be so qualified.

Rule 506 also requires that the issuer reasonably believe there are no more than thirty-five "purchasers" of securities from the issuer in any offering made pursuant to the rule.[107] As defined by Rule 501(e), however, certain persons related to the purchaser and all accredited investors are excluded from the computation of the number of total purchasers.[108] Under Rule 506, therefore, an issuer can sell its securities to up to thirty-five unaccredited purchasers, as calcu-

105. *Id.* § 230-501(a). For purposes of determining net worth, the joint net worth of the purchaser and the purchaser's spouse may be used.

106. The term "purchaser representative" is defined by Rule 501(h) to mean a person who satisfies the following conditions or a person who the issuer reasonably believes satisfies these conditions. First, subject to certain exceptions, the purchaser representative must have no managerial, employment or major equity ownership relationship to the issuer. Second, the purchaser representative must be sufficiently knowledgeable and experienced in financial and business matters to evaluate, either alone or together with other qualified purchaser representatives, or with the purchaser, the merits and risks of an investment in the issuer. Third, the purchaser must acknowledge in writing the role of the purchaser representative in connection with the investment in the issuer. Finally, prior to such acknowledgement, the purchaser representative must disclose in writing any material relationship between himself or his affiliates and the issuer or its affiliates that then exists, that is mutually understood to be contemplated, or that has existed at any time during the previous two years, and any compensation received or to be received as a result thereof. Advance blanket acknowledgement is not sufficient to satisfy this requirement. The acknowledgement and the disclosure required thereby must be made with specific reference to each prospective investment. Furthermore, disclosure of material relationships does not relieve the purchaser representative of his obligation to act in the interest of the purchaser. *Id.* § 230.501(h).

107. *Id.* § 230.506(b)(2)(i).

108. *Id.* § 230.501(e)(1). In addition to accredited investors, excluded purchasers include any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser or any trust, estate, corporation or similar entity in which such purchaser or such relatives have a more than 50 percent beneficial interest in the aggregate. For purposes of this computation, a corporation, partnership or other entity is counted as one purchaser. If, however, that entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor, then each beneficial equity owner counts as a separate purchaser. *Id.* § 230.506(b)(2)(ii).

lated according to Rule 501(e), plus an unlimited number of accredited investors.

Manner of the Offering. Rule 506 requires that all offers and sales made pursuant to the rule satisfy the conditions set forth in Rule 502(c) of Regulation D concerning limitations on the manner of offering. These conditions prohibit general solicitation or general advertising, including (i) advertisements and other communications published in any newspaper, magazine, or similar media or broadcast over television or radio, and (ii) seminars or meetings whose attendees have been invited by any general solicitation or general advertising.[109]

Information Requirements. Offers and sales made in reliance upon the Rule 506 safe harbor must satisfy the information requirements set forth in Rule 502(b) of Regulation D.[110] These requirements differ depending on whether or not the offering is sold to accredited investors.

Provided all purchasers in a Rule 506 offering are accredited investors, an issuer is not required to furnish any specific information to the purchasers. In practice, however, substantial information about the issuer and the securities being offered generally is provided.[111]

In a Rule 506 offering involving even one purchaser who is not an accredited investor, an issuer must supply all purchasers with the information specified in Rule 502(b) of Regulation D. Generally, an issuer that is a foreign bank must furnish the same kind of information that would be required by Form F-1 under the Securities Act.[112] For offerings of $5 million or less, only the financial statements for the most recent fiscal year need be audited. Moreover, for any size offering, if the foreign bank is unable to obtain audited financial information without unreasonable effort or expense, only the balance sheet must be audited. If the foreign bank is subject to the reporting

109. *Id.* § 230.502(c).

110. *Id.* § 230.502(b).

111. Notwithstanding the exemption from the registration requirements of the Securities Act afforded by Rule 506, the anti-fraud provisions of the Securities Act and probably the Exchange Act are still applicable to the offer and sale of the securities. *See infra* notes 134-38, 158-66 and accompanying text. Consequently, most issuers generally provide disclosures sufficient to satisfy those provisions.

112. 17 C.F.R. § 230.502(b)(2)(i) (1985). For a discussion of Form F-1 under the Securities Act, see *infra* notes 398-400 and accompanying text. Exhibits required to be filed with the SEC as part of a registation statement or report need not generally be furnished to each purchaser if the contents of the exhibits are identified and the exhibits are made available to the purchaser, upon his written request, prior to his purchase. 17 C.F.R. § 230.502(b)(2)(iii) (1985).

requirements of the Exchange Act, the bank may satisfy the requirements of Rule 502(b) by furnishing the information contained in its most recent filing on Form 20-F under the Exchange Act in lieu of the above information.[113]

Filing Requirements. Five copies of a notice on Form D must be filed with the SEC no later than 15 days after the first sale of securities in an offering made pursuant to Rule 506. This form also must be filed every six months after the first sale until a final notice is filed no later than 30 days after the last sale of securities. If the offering is completed within the initial 15 day period, however, only one notice need be filed.[114]

(C) *Integration and Resale Restrictions*

Even if an offering of securities otherwise satisfies the requirements for an exemption from registration under Section 4(2) of the Securities Act or Rule 506 of Regulation D thereunder, the issuer of the securities must ensure that the offering is not combined with other offers or sales that would make the offering part of a larger public offering. As discussed below, this may happen in one of two ways: (i) the offering may be integrated with other securities offerings made by the issuer at about the same time; or (ii) resales by purchasers of the offered securities may be considered a continuation of the initial offering.

Integration. The doctrine of integration has been developed by the SEC and the courts to prevent issuers from circumventing the registration requirements of the Securities Act by issuing successive offerings, each of which appears to qualify separately for an exemption from registration but which is actually part of a single plan of financing that otherwise would be subject to the registration require-

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113. 17 C.F.R. § 230.502(b)(2)(ii)(C) (1985). For a discussion of Form 20-F under the Exchange Act, see *infra* notes 389-97 and accompanying text. Rule 502(b) also requires that issuers make available to each purchaser the opportunity to ask questions and receive answers concerning the offering and to obtain any other relevant information which the issuer possesses or can acquire without unreasonable effort or expense. 17 C.F.R. § 230.502(b)(2)(v) (1985). Prior to any Rule 506 purchase by a purchaser who is not an accredited investor, the issuer also must furnish to the purchaser a brief written description of any written information concerning the offering which the issuer had furnished to any accredited investor and, if requested, the actual information so furnished. *Id.* § 230.502(b)(2)(iv). If the offering involves a business combination, the issuer also must provide to each purchaser written information about any terms or arrangements of the proposed transaction which differ materially from those applicable to any other security holders. *Id.* § 230.502(b)(2)(vi).

114. 17 C.F.R. § 230.503(b) (1985).

ments.[115] The courts and the SEC have identified the following five factors as relevant in considering whether different offerings should be integrated, both for purposes of Section 4(2) and Rule 506: (i) whether the offerings are part of a single plan of financing; (ii) whether the offerings involve issuance of the same class of security; (iii) whether the offerings are made at or about the same time; (iv) whether the same type of consideration is to be received; and (v) whether the offerings are made for the same general purpose.[116]

It is unclear how much time must elapse between offerings to preclude the possibility that an offering pursuant to Section 4(2) of the Securities Act will be integrated with another offering by the issuer. For purposes of Rule 506 transactions, however, a safe harbor in Regulation D provides that offers and sales made six months prior to or after any Rule 506 offering will not be integrated with the Rule 506 offering so long as there are no offers or sales of securities of the same or a similar class by or for the issuer during such six month periods (other than under an employee benefit plan, as defined).[117]

In addition, for purposes of both Section 4(2) and Rule 506, an offering meeting the requirements for the private placement exemption generally will not be integrated with a simultaneous offering that is not required to be registered under the Securities Act because it is made outside the United States.[118] The SEC also has adopted Rule 152 to eliminate integration concerns that may arise when the issuer makes a private placement pursuant to Section 4(2) of the Securities Act followed by a public offering or the filing of a registration statement under the Securities Act.[119]

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115. The SEC has defined integration as a "concept by which two or more offerings which are intended to be exempt from registration could be combined into one offering with a resulting violation of the registration provisions of the Securities Act." SEC Securities Act Release No. 6339 (Aug. 7, 1981), 46 Fed. Reg. 41,791 (1981).

116. Securities Act Release No. 4552, *supra* note 77; 17 C.F.R. § 230.502(a) (1985). The SEC staff, reversing a policy in effect for several years, indicated informally in 1985 that it will again issue no-action letters concerning integration questions in appropriate circumstances.

117. 17 C.F.R. § 530.502(a) (1985).

118. An offering made outside of the United States by a foreign bank would not need to be registered under the Securities Act if it did not make use of any means or instrumentality of United States interstate commerce or of the United States mails. 15 U.S.C. § 77e(a) (1982). The SEC has determined that even offerings by United States issuers need not be integrated with a private placement in the United States provided the offering is made outside the United States to non-United States persons in a manner that will result in the securities coming to rest abroad. SEC Securities Act Release No. 4708 (July 9, 1964), 29 Fed. Reg. 9,828 (1964), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶¶ 1361-1363, at 2123. *See, e.g.*, First Interstate Bancorp, SEC No-Action Letter (available Feb. 12, 1986, on LEXIS, Fedsec library, Noact file).

119. Rule 152 provides:

Limitations on Resale. Under certain circumstances, persons who resell securities purchased from an issuer in an attempted private placement may, in fact, be distributing the securities to the public, thereby destroying the issuer's private offering exemption. Persons who purchase from an issuer with a view to the distribution (i.e., the public offering) of a security are deemed to be "underwriters" of the issuer's securities within the meaning of Section 2(11) of the Securities Act.[120] An issuer attempting to make an effective private placement under either Section 4(2) or Rule 506, therefore, must take precautionary measures to ensure that the initial purchasers in the offering do not acquire the securities with a view to distribution of the securities.

In this regard, issuers generally obtain written assurances or representations (generally called "investment letters") from each purchaser that such purchaser is not acquiring the securities with a view to their distribution and will not resell the securities unless they are registered under the Securities Act or are sold in a transaction exempt from registration.[121] The SEC and the courts also have indicated that the use of a legend on the certificates representing the securities which sets forth restrictions on their transfer, and of stop-transfer instructions given to the issuer's transfer agent, will be fac-

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The phrase "transactions by an issuer not involving any public offering" in Section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement.

17 C.F.R. § 230.152 (1985). *See e.g.*, Verticom, Inc., SEC No-Action Letter (available Feb. 12, 1986, on LEXIS, Fedsec library, Noact file).

120. Section 2(11) of the Securities Act defines, in relevant part, the term "underwriter" to mean:

any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual or customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

15 U.S.C. § 77(b)(11) (1982).

121. Further control over the resales can be obtained by requiring that transfers of the securities may not be made without the prior approval of the issuer, its counsel, or its agent. These procedures generally have been codified in Regulation D as conditions to the availability of the Rule 506 safe harbor. 17 C.F.R. § 230.502(d) (1985).

tors indicative of the issuer's intent to prevent public resales of the securities offered in a Section 4(2) private placement.[122]

In light of the transfer restrictions on securities acquired from an issuer in a private placement, the securities generally are referred to as "restricted" securities[123] and cannot be resold without registration under the Securities Act or in a transaction exempt from registration. Securities acquired pursuant to a transaction exempt by Rule 506 of Regulation D take the same status as restricted securities under Section 4(2).[124]

An exemption for resales is provided by Section 4(1) of the Securities Act which exempts from registration "transactions by any person other than an issuer, underwriter, or dealer."[125] However, as discussed above, the term "underwriter" is broadly defined to include any person (not just a professional underwriter) who purchases from an issuer with a view to, or sells for an issuer in connection with, a distribution (i.e., a public offering) of the issuer's securities.[126]

Since it is difficult to ascertain the actual intent of a purchaser, the length of the purchaser's holding period prior to resale generally is viewed as an indication of his investment intent. As a result, if a purchaser of restricted securities holds the securities for a sufficient length of time (i.e., several years), he presumably will not be an underwriter and, pursuant to Section 4(1) of the Securities Act, may resell the securities publicly and without restriction.[127] Since there is no time period that conclusively determines when a purchaser can resell restricted securities pursuant to Section 4(1) of the Securities

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122. *See* SEC Securities Act Release No. 5121 (Dec. 30, 1970), 36 Fed. Reg. 1525 (1970), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2784, at 2922; Livens v. William D. Witter, Inc., 374 F. Supp. 1104, 1110 (D. Mass. 1974). Restrictive legends are a specific condition to an offering under Rule 506 (17 C.F.R. § 230.502(d) (1984)) and may provide additional protection to an issuer in offerings made under Section 4(2), particularly if the securities are sold to individuals rather than to institutions. An issuer also should issue instructions to its transfer agent not to effect transfers of the securities in the absence of express authorization to the contrary.

123. The term "restricted securities" is defined in Rule 144 under the Securities Act, 17 C.F.R. § 230.144(a)(3) (1985).

124. *See id.* § 230.502(d).

125. 15 U.S.C. § 77d(1) (1982). The term "issuer" is defined *supra* note 72. The term "dealer" is defined in Section 2(12) of the Securities Act, 15 U.S.C. § 77b(12) (1982).

126. *See supra* note 120.

127. Since an affiliate of an issuer (i.e., a person controlling, controlled by, or under common control with, the issuer) is deemed an issuer for purposes of Section 2(11) of the Securities Act, *supra* note 120, any public sales by the affiliate will be deemed sales to an underwriter (i.e., a person purchasing from an issuer with a view to distribution). As a result, except as discussed *infra* note 120 and accompanying text, an affiliate of an issuer is limited in his ability to make resales of securities pursuant to Section 4(1) of the Securities Act.

Act,[128] the SEC adopted Rule 144 under that section to provide a safe harbor for public resales of restricted securities after a specified holding period.[129]

If a purchaser wishes to sell restricted securities prior to meeting the holding period requirements of Rule 144, the securities may be able to be sold privately pursuant to a statutory exemption generally referred to as the "Section 4(1-½)" exemption. The exemption is so named because, while technically the exemption is under Section 4(1) of the Securities Act, its availability requires that the resales also satisfy some of the criteria for a private placement under Section 4(2).[130] Although the determination of the particular 4(2) criteria which must be satisfied is the inter-related product of judicial decisions,[131] SEC interpretive no-action letters,[132] and professional

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128. *See* United States v. Sherwood, 175 F. Supp. 480,483 (S.D.N.Y. 1959) (defendant who took unrestricted ownership of shares in September 1957 and sold a portion of the block in September 1959 did not take shares with a view to distribution).

129. 17 C.F.R. § 230.144 (1985). Rule 144 generally provides that restricted securities may be resold in brokerage transactions provided the seller complies with a number of conditions, including a two-year holding period (as defined in 17 C.F.R. § 230.144(d) (1985)), volume limitations, and the manner of sale. In addition, the rule provides that non-affiliates of the issuer may resell without restriction securities they have held for at least three years (as determined in accordance with the Rule's provisions). *Id.* § 230.144(k).

130. In a footnote to a 1980 release, the SEC stated that:

> In making such private sales, the affiliates presumably would rely on the so-called "Section 4(1-½)" exemption. This is a hybrid exemption not specifically provided for in the 1933 Act but clearly within its intended purpose. The exemption basically would permit affiliates to make private sales of securities held by them so long as some of the established criteria for sales under both Section 4(1) and Section 4(2) of the Act are satisfied.

SEC Securities Act Release No. 6188, n.178 (Feb. 1, 1980), 1 FED. SEC. L. REP. (CCH) ¶ 1051, at 2073-2. *See* ABA Subcommittee on 1933 Act, *The Section 4(1-½) Phenomenon: Private Resales of "Restricted" Securities*, 34 BUS. LAW. 1961 (1979) [hereinafter cited as ABA Subcommittee on the 1933 Act]. Although the Section 4(1-½) exemption is similar to the private placement exemption under Section 4(2), the latter exemption is available only to issuers and, therefore, is not available for secondary transactions.

131. *See, e.g.*, Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959) (resales of unregistered securities to purchasers who did not have access to information concerning the company and its affairs gave rise to a public offering); Fuller v. Dilbert, 244 F. Supp. 196 (S.D.N.Y. 1965), *aff'd*, 358 F.2d 305 (2d Cir., 1966) (resales of unregistered stock to a few sophisticated investors who had easy access to the kind of information provided by registration did not involve any public offering); The Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,523, at 94,953 (S.D.N.Y. 1965) (resales to mutual funds which were recognized as sophisticated investors with sufficient access to information did not constitute a public offering).

132. *See, e.g.*, Gralla Publications, Inc., SEC No-Action Letter (available Feb. 18, 1977, on LEXIS, Fedsec library, Noact file); Mary Elizabeth Sealander, SEC No-Action Letter (available Sept. 19, 1977, on LEXIS, Fedsec library, Noact file); Colorado & Western Properties, Inc., SEC No-Action Letter (available July 14, 1977, on LEXIS, Fedsec library, Noact file).

commentaries,[133] it is reasonably clear that the exemption is available if the resale is effected so that the private placement exemption relied upon by the issuer in the initial offering would not be lost if the resale were considered an integral part of that initial offering. Accordingly, if the transaction satisfies all the conditions for a private placement and the restrictions on subsequent resale discussed above in this section, the Section 4(1-½) exemption will be available.

vi. *Liability Provisions*

Foreign banks that offer securities in the United States are subject to certain potential civil liabilities under the Securities Act for fraudulent activities in connection with those offerings. Section 11(a) of the Securities Act imposes civil liability for any material omissions or misstatements contained in a registration statement on every person who signed the registration statement (which, as discussed below in Section III.A.3.a, includes the issuer and certain of its officers and directors), the issuer's directors, partners, underwriters and accountants, and certain other persons.[134]

Section 12 of the Securities Act also subjects issuers and other persons to civil liability for offering or selling securities in the United States by means of a prospectus or oral communication that includes materially false or misleading information unless, in the exercise of reasonable care, they could not have known of the inaccuracy of the information.[135] This Section is applicable to both registered offerings

133. *See, e.g.*, Lockary, *Reinterpreting the "Section 4(1-½)" Exemption from Securities Registration: The Investor Protection Requirement*, 16 U.S.F.L. REV. 681 (1982); ABA Subcommittee on 1933 Act, *supra* note 130; ABA Committee on Developments in Business Financing, *Resale by Institutional Investors of Debt Securities Acquired in Private Placements*, 34 BUS. LAW. 1927 (1979).

134. 15 U.S.C. § 77k(a) (1982). Pursuant to Section 11(b), however, a person other than the issuer generally has a defense to this liability if he can prove he made a reasonable investigation of and had reasonable grounds to believe in the accuracy of the disclosures set forth in the registration statement. *Id.* § 77k(b). In addition, to address certain concerns relating to the incorporation by reference of outdated or incorrect information into a registration statement as might occur pursuant to one of the registration forms for foreign private issuers discussed *infra* notes 398-403 and accompanying text, Rule 412 under the Securities Act provides that: (i) a statement contained in a document incorporated by reference into a registration statement shall be deemed superseded by any subsequent modifying statement contained in or incorporated by reference into the registration statement, (ii) a statement modifying a prior statement will not be deemed an admission that the prior statement violated the securities laws, and (iii) a superseded statement will not be deemed to constitute a part of the registration statement. 17 C.F.R. § 230.412 (1985).

135. 15 U.S.C. § 771 (1982).

and offerings exempt from registration, unless the securities sold are exempt by virtue of Section 3(a)(2) of the Securities Act.[136]

Section 15 of the Securities Act imposes joint and several liability on persons controlling the issuer or other persons subject to liability under Sections 11 or 12, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts giving rise to the controlled person's liability.[137] In addition, Section 17 of the Securities Act makes it unlawful for any person in the offer or sale of a security to make any materially false or misleading statements or to engage in any fraudulent or deceptive practices.[138]

b. *The Exchange Act*

As a supplement to the Securities Act, which is designed to regulate public offerings of securities, the Exchange Act is designed to promote full disclosure of material information regarding securities that are traded in the secondary markets in the United States and to prohibit fraud and other deceptive practices in connection with the trading of such securities. These objectives are furthered by requiring certain issuers to register their securities with the SEC, by subjecting issuers whose securities are publicly traded in the United States to continuous reporting requirements, and by prohibiting and imposing liability with respect to fraudulent practices in connection with the securities markets.

i. *Registration Requirements*

The registration requirements of Section 12 of the Exchange Act are applicable to (i) debt and equity securities listed on a United States securities exchange and (ii) equity securities of issuers meeting certain asset and shareholder criteria.[139] For purposes of the Exchange Act, an equity security would include common and preferred

136. *Id.* For a discussion of the exemption for bank issued and guaranteed securities pursuant to Section 3(a)(2) of the Securities Act, see *infra* notes 351-64 and accompanying text.

137. 15 U.S.C. § 77o (1982).

138. *Id.* § 77q.

139. The term "security" is defined in Section 3(a)(10) of the Exchange Act in a manner similar to the definition of a security under the Securities Act. *See supra* note 25. The Exchange Act definition, however, does not include an "evidence of indebtedness" or a "guarantee" of a security and specifically excludes "currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." 15 U.S.C. § 78c(a)(10) (1982).

stock and securities exchangeable into or representing stock, such as convertible debt securities and ADRs.[140]

Section 12(b) of the Exchange Act requires that every issuer, whether foreign or domestic, register with the SEC any security which is registered on a national securities exchange.[141] There are no exemptions from this requirement.

Section 12(g)(1) of the Exchange Act provides that every issuer which is engaged in interstate commerce, or whose securities are traded by any means of interstate commerce, and which has (i) total assets exceeding $1 million and (ii) a class of equity securities held of record by 500 or more persons must register those securities with the SEC.[142] Pursuant to Rule 12g-1 under the Exchange Act, however, an issuer is exempt from the registration requirements of Section 12(g) if, on the last day of its most recent fiscal year, the issuer had total assets not exceeding $3 million.[143] This exemption is available to all domestic issuers and to foreign private issuers[144] whose securities are not quoted through an automated inter-dealer quotation system, such as the National Association of Securities Dealers Automated Quotation System (NASDAQ).[145] As a result of Rule 12g-1, an issuer, whether domestic or foreign, generally becomes subject to the registration requirements of Section 12(g) of the Exchange Act only if it has (i) total assets exceeding $3 million and (ii) a class of equity securities held of record by 500 or more persons.

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140. The term "equity security" is defined in Section 3(a)(11) of the Exchange Act, 15 U.S.C. § 78c(a)(11) (1982), and in Rule 3a11-1 promulgated under the Exchange Act, 17 C.F.R. § 240.3a11-1 (1985).

141. 15 U.S.C. § 781(b) (1982).

142. *Id.* § 781(a)(1).

143. 17 C.F.R. § 240.12g-1 (1985).

144. Rule 3b-4 under the Exchange Act defines the term "foreign private issuer" in a manner similar to the definition of the term under the Securities Act, *supra* note 23. 17 C.F.R. § 240.3b-4 (1985).

145. Like domestic issuers, foreign issuers currently including their securities in NASDAQ are required to register the securities under the Exchange Act. By-Laws of National Association of Securities Dealers, Inc., Sched. D. *National Association of Securities Dealers Manual* (CCH) [hereinafter cited as NASD Manual] ¶ 1653A, at 1138 (1983) [hereinafter cited as Schedule D]. In the past, however, foreign securities that were exempt from the registration requirements of the Exchange Act pursuant to Rule 12g3-2, discussed *infra* notes 147-53 and accompanying text, could be included in NASDAQ without the participation of the foreign issuer. Now that inclusion of a foreign issuer's securities in NASDAQ requires the cooperation of the foreign issuer, the SEC views this step as voluntary entry by the foreign issuer into the United States markets. SEC Securities Exchange Act Release No. 20264 (Oct. 6, 1983), 48 Fed. Reg. 46,736 (1983), *reprinted in* [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,435, at 86,292. As a result, the SEC has determined that foreign private issuers with securities included in NASDAQ are not entitled to exemptions from Section 12(g) of the Exchange Act that are unavailable to domestic issuers. *Id.*

A foreign bank that qualifies as a foreign private issuer may register securities under the Exchange Act by filing a registration statement on Form 20-F for foreign private issuers.[140]

ii. *Exemptions for Foreign Issuers*

Section 12(g)(3) of the Exchange Act gives the SEC broad authority to exempt from the requirements of Section 12(g) of the Exchange Act any security of a foreign private issuer, including foreign banks.[147] Pursuant to this authority, the SEC has adopted Rule 12g3-2, which is designed to reduce the regulatory burden that otherwise would be imposed on foreign private issuers whose securities are traded in the United States without any act by the issuer to cause the trading to occur.[148] Rule 12g3-2 contains three limited exemptions from Section 12(g).

First, Rule 12g3-2(a) exempts securities of any class issued by a foreign bank or other foreign private issuer if the class of securities has fewer than 300 holders resident in the United States.[149] This exemption continues until the end of the next fiscal year at which the issuer has a class of equity securities held by 300 or more persons resident in the United States.

Second, Rule 12g3-2(b) exempts the securities of foreign banks and other foreign private issuers that furnish specified information to the SEC and satisfy the requirements of paragraph (d) of Rule 12g3-2. The information that a foreign private issuer is required to furnish to the SEC pursuant to this exemption includes, among other things, information that the issuer (i) has made or is required to make public in its home country, (ii) has filed or is required to file with a foreign stock exchange on which its securities are traded and by which the information has been made public, or (iii) has distrib-

146. 17 C.F.R. § 249.220f (1985). *See infra* notes 389-97 and accompanying text. Alternatively, a foreign private issuer that has filed a registration statement under the Securities Act or that is listing its securities on a national securities exchange may choose to register its securities under the Exchange Act by filing Form 8-A, a short registration form also available to domestic issuers. 17 C.F.R. § 249.8a (1985). Form 8-A requires only a description of the securities being registered and various exhibits pertaining to the securities.

147. 15 U.S.C. § 781(a)(3) (1982).

148. 17 C.F.R. § 240.12g3-2 (1985).

149. *Id.* § 240.12g3-2(a) (1985). For purposes of determining the number of holders in the United States, securities held of record by persons resident in the United States shall be determined as provided in Rule 12g5-1 under the Exchange Act (*id.* § 240.12g5-1), except that securities held of record by a broker, dealer, bank or nominee for the account of customers resident in the United States shall be counted as held in the United States by the number of separate accounts for which the securities are held. *Id.* at § 240.12g3-2(a).

uted or is required to distribute to its security holders. This information is not deemed to be "filed" with the SEC and does not subject the issuer to the liabilities of Section 18 of the Exchange Act.[150]

As set forth in subparagraph (d) of Rule 12g3-2, the exemption provided in Rule 12g3-2(b) is not available to securities of foreign banks or other foreign private issuers that have taken any of the following voluntary steps to enter the United States markets: (i) during the prior eighteen months, the issuer has had the securities registered under Section 12 of the Exchange Act or has had an active or suspended reporting obligation under Section 15(d) of the Exchange Act as a result of a prior public offering registered under the Securities Act;[151] (ii) the issuer has issued the securities in a transaction to acquire another issuer subject to the reporting requirements of the Exchange Act; or (iii) the issuer's securities are quoted in an automated inter-dealer quotation system, such as NASDAQ, or are represented by ADRs so quoted, unless specified grandfather provisions are satisfied.[152]

Third, Rule 12g3-2(c) exempts from Section 12(g) all depository shares registered on Form F-6, the form used to register securities evidenced by ADRs under the Securities Act.[153] The exemption does not apply to the underlying securities of the foreign issuer deposited for the ADRs.

iii. *Continuous Reporting Requirements*

Pursuant to Section 13 of the Exchange Act, every issuer, whether domestic or foreign, that has securities registered pursuant to Section 12 of the Exchange Act must file various periodic and other reports with the SEC and with any national securities exchange on which the issuer's securities are listed.[154] A foreign bank eligible to

150. See the discussion of Section 18 *infra* notes 157-66 and accompanying text.

151. *See infra* notes 154-57 and accompanying text.

152. 17 C.F.R. § 240.12g3-2(d) (1985). The grandfather provision applies to securities of foreign private issuers quoted on an automated interdealer quotation system on October 5, 1983, that have been continuously traded since that time, provided that the foreign private issuer was in compliance on October 5, 1983, and continues to be in compliance with the exemption in Rule 12g3-2(b). Canadian issuers are grandfathered only until January 2, 1986. *Id.* § 240.12g3-2(d)(3). *See* SEC Securities Exchange Act Release No. 20,265 (Oct. 6, 1983), 48 Fed. Reg. 46,737 (1983), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 23,317, at 17,145.

153. A depositary share is defined as "a security, evidenced by an American Depositary Receipt, that represents a foreign security or a multiple of or fraction thereof deposited with a depositary." 17 C.F.R. § 230.405 (1985). *See supra* note 19 and *infra* notes 404-05 and accompanying text.

154. 15 U.S.C. § 78m(a) (1982). As a result of using Form 20-F to register a class of equity securities under Section 12 of the Exchange Act, the issuer becomes subject to the

use Exchange Act Form 20-F, the annual report and registration form for foreign private issuers, may satisfy its reporting obligations under Section 13 by (i) filing an annual report on Form 20-F within six months after the end of the issuer's fiscal year and (ii) furnishing to the SEC interim reports on Form 6-K.[155]

Pursuant to Section 15(d) of the Exchange Act, foreign private issuers that have registered securities offerings under the Securities Act are required to file the same annual and interim reports required by Section 13 of the Exchange Act.[156] This reporting obligation is suspended, however, if (i) during any fiscal year commencing after the registration statement becomes effective, the class of registered securities is held of record at the beginning of the year by fewer than 300 persons or (ii) the issuer registers a class of equity securities

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reporting requirements of Section 13(a) of the Exchange Act (15 U.S.C. § 78m(a) (1982) and Regulation 13A thereunder.

155. *See* 17 C.F.R. §§ 240.13a-1, 13a-16 (1985). The conditions for use of Form 20-F and the disclosure requirements of the form are discussed *infra* notes 389-97 and accompanying text. Canadian issuers, including Canadian banks, are eligible to use Form 20-F as an annual report if those issuers, during the past year, have not had securities listed on a national securities exchange and have not had an active or suspended reporting obligation under Section 15(d) of the Exchange Act. These issuers may satisfy their reporting obligations pursuant to Section 13 of the Exchange Act by filing annual reports on Form 20-F and interim reports on Form 6-K. *See* Form 20-F, General Instruction A(b). Other Canadian issuers must satisfy their reporting obligations under the Exchange Act by filing the reports required of domestic issuers. The securities of foreign governments and political subdivisions thereof, including securities of foreign government owned banks that are guaranteed by the foreign government, are not subject to the continuous reporting requirements of the Exchange Act unless the securities are listed on an United States exchange. *See* SEC Securities Act Release No. 6424 (Sept. 2, 1982), 47 Fed. Reg. 39,809 (1982), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 3850A, at 3377. In this event, the issuer may register the securities pursuant to Section 12(b) of the Exchange Act on Form 18 and file annual reports on Form 18-K. These forms generally track the disclosure requirements of Schedule B under the Securities Act, discussed *infra* notes 389-97.

Form 6-K must include information that the registrant: (i) is required to make public in its home country or pursuant to the laws of that country; (ii) has filed with a foreign securities exchange on which its securities are traded and which was made public by that exchange; or (iii) has distributed to its security holders. Except for press releases and communications to security holders, a brief summary in English may be substituted for documents for which no English language translation exists. Form 6-K, General Instruction B, *id.* § 249.306. Form 6-Ks must be furnished to the SEC promptly after the information to be disclosed therein is made public and shall not be deemed "filed" for purposes of the liability provisions of Section 18 of the Exchange Act. Issuers of ADRs evidencing foreign securities need not furnish Form 6-Ks. *Id.* § 240.13a-16.

156. 15 U.S.C. § 78o(d) (1982). Form 20-F and Form 6-K are required by 17 C.F.R. §§ 240.15d-1, .15d-16 (1985).

under Section 12 of the Exchange Act and pursuant to that section files reports under Section 13.[157]

iv. *Liability Provisions*

The Exchange Act imposes liability for false or misleading statements contained in documents filed under that statute. Pursuant to Section 18 of the Exchange Act, a foreign bank that makes or causes to be made any materially false or misleading statement in an Exchange Act report filed with the SEC, such as a Form 20-F, may be liable to a person who relied on the misstatement in the purchase or sale of a security at a price which was affected by the misstatement.[158] Liability under this section is subject to the defense that the person being sued acted in good faith and had no knowledge that the statement was false or misleading.

Foreign banks that offer securities in the United States, or whose securities are traded in the United States, also may be subject to liability pursuant to the general anti-fraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[159] These provisions are applicable regardless of whether the securities are registered under the Exchange Act and generally require issuers to make certain disclosures in connection with their securities offerings in the United States even if the offerings are not subject to the disclosure requirements imposed by the Securities Act.[160] Since the provisions apply only to securities, however, the degree of disclosure required will depend on whether the issuer's obligations, such as short-term commercial paper or certificates of deposit, are securities within the meaning of the Exchange Act.[161]

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157. Moreover, the reporting requirements under Section 15(d) are not applicable to depositary shares registered on Form F-6, if, as discussed *infra* note 405, the depositary furnishes to the SEC and to security holders the information required by that form. *See* 17 C.F.R. § 240.15d-3 (1985).

158. As discussed *supra* note 155, Form 6-Ks are not deemed "filed" with the SEC and, therefore, will not subject a foreign private issuer to liability under Section 18 of the Exchange Act.

159. 15 U.S.C. § 78j(b) (1982) and 17 C.F.R. § 240.10b-5 (1985), respectively.

160. *See, e.g.*, discussion of the disclosures required in private placement transactions exempt from registration under the Securities Act, *supra* notes 89-99 and accompanying text.

161. Although notes, certificates of deposit, and other instruments with a maturity of nine months or less do not literally fall within the definition of a security in Section 3(a)(10) of the Exchange Act, the courts generally have found that the exclusion for short-term instruments applies only to "commercial" rather than "investment" notes or to the type of commercial paper exempt under Section 3(a)(3) of the Securities Act. *See, e.g.*, Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972); Banowitz v. State Exchange Bank, No. 84 C 2818 (N.D. Ill. Jan. 18, 1985). For a discussion of exempt commercial

Issuers with securities registered under Section 12 generally are subject to the proxy solicitation and tender offer requirements of Section 14 of the Exchange Act and the insider trading restrictions of Section 16.[162] Rule 3a12-3 under the Exchange Act, however, exempts securities registered by a foreign private issuer, including a foreign bank, eligible to use Form 20-F from the proxy solicitation and insider trading provisions contained in Sections 14(a), 14(b), 14(c), 14(f), and 16 of the Exchange Act.[163] A foreign issuer, nevertheless, would remain subject to the issuer repurchase and tender offer provisions of Section 13(e) and Sections 14(d) and (e) of the Exchange Act, and the SEC's rules thereunder, which impose certain conditions on the issuer during tender offers for its securities, including tender offers by an issuer for its own securities, and certain other purchases by the issuer of its own securities.[164]

Another provision relevant to foreign banks is Section 30A of the Exchange Act, the Foreign Corrupt Practices Act of 1977, which governs foreign corrupt practices of issuers that have securities registered under Section 12 of the Exchange Act or that are subject to the reporting requirements of Section 15(d) of the Exchange Act by virtue of having registered a prior securities offering under the Securities Act.[165] This section generally prohibits the issuer, its officers, directors, employees or agents, and any stockholder acting on its behalf from using the mails or any means of interstate commerce to make improper payments to foreign government officials. Although this Section applies to foreign issuers, in most cases it would appear difficult to establish the use by a foreign issuer of the United States mails or the instrumentalities of interstate commerce in the United States in furtherance of an improper payment, as is required by Section 30A.

As with Section 15 of the Securities Act, Section 20 of the Exchange Act imposes joint and several liability on any person controlling another person liable under any provisions of the Exchange Act,

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paper under the Securities Act, see *supra* notes 38-68 and accompanying text. For a discussion of certificates of deposit as securities, see *supra* notes 27-37 and *infra* notes 309-13 and accompanying text. If an issuer's obligations are not securities, disclosure generally will be based on market and business considerations, or requirements imposed by an applicable banking regulator, rather than on the requirements of the federal securities laws.

162. 15 U.S.C. §§ 78n, p (1982).

163. 17 C.F.R. § 240.3a12-3 (1985).

164. *See id.* §§ 240.13e-1, 13e-3, 13e-4, 14d-1 to e-3.

165. 15 U.S.C. § 78dd-1 (1982).

unless the controlling person acted in good faith and did not induce the acts giving rise to the cause of action.[166]

c. *The Investment Company Act*

The Investment Company Act was intended to cure abuses and dangers which were perceived to be peculiar or specifically applicable to investment companies[167] and which were not addressed adequately by the statutory framework already in place at the time of its enactment.[168] The central provision of the Investment Company Act is Section 7 which, among other things, prohibits any investment company, unless registered with the SEC under the Investment Company Act, from offering its securities to the public in the United States.[169] Under Section 8 of the Investment Company Act, an investment company created under the laws of the United States or its territories may register with the SEC as of right by filing a notification of registration and, contemporaneously or subsequently, a registration statement on the prescribed form along with the required fee.[170] Registration of a domestic investment company under the Investment Company Act is effective immediately upon receipt by the SEC of the notification of registration.[171]

With respect to a foreign investment company, however, registration with the SEC is available only upon the order of the SEC. Under Section 7(d), the SEC is authorized to issue an order permitting a foreign investment company to register under the Investment Company Act only if it finds that "by reason of special circumstances or arrangements it is both legally and practically feasible" to

166. *Id.* § 78t.

167. Section 1 of the Investment Company Act lists several abuses to which investment companies may be susceptible, such as insufficient information to stockholders, inadequate assets, excessive borrowing, and unsound or misleading accounting methods. The purpose of the Investment Company Act, as set forth in Section 1, is "to mitigate and, so far as is feasible, to eliminate" those abusive conditions. *Id.* § 80a-1(b).

168. The most significant statutes previously enacted were the Securities Act and the Exchange Act, which are discussed *supra* notes 22-166 and accompanying text.

169. 15 U.S.C. § 80a-7(a) (1982).

170. *Id.* § 80a-8. The type of form to be filed by the registrant depends on the category of investment company under the classification scheme of the Investment Company Act to which the company belongs. Open-end investment companies use Form N-1A, closed-end investment companies use Form N-2, and unit investment trusts use Form N-8B-2. With the exception of Form N-8B-2, these forms also constitute the registration statement under the Securities Act for an investment company engaging in a public offering.

171. An investment company registering under the Investment Company Act and registering its shares under the Securities Act may not commence a public offering of its shares until its registration statement under the Securities Act becomes effective.

enforce the provisions of the Investment Company Act against the investment company, and that permitting registration is otherwise consistent with "the public interest and the protection of investors."[172] The SEC may impose conditions on the investment company in the order permitting registration.

i. *Definition of Investment Company*

A foreign bank which seeks to issue securities in the United States, either directly or by guaranteeing the securities of a United States finance or other subsidiary,[173]

> must first determine whether or not it is an investment company under the Investment Company Act. Section 3(a) of the Investment Company Act defines investment company to mean any issuer which:
> (1) is or holds itself out as being engagaed primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
> (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificates outstanding; or
> (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities and owns or proposes to acquire investment securities having a value exceeding 40 percentum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. As used in this section "investment securities" includes all securities except (A) Government securities, (B) securities issued by employees' securities companies and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies.[174]

Under Section 3(a), any entity which is within either the Section 3(a)(1) or the Section 3(a)(3) test is deemed to be an investment

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172. 15 U.S.C. § 80a-7(d) (1982).

173. If securities issued by a finance or other subsidiary of a foreign bank are guaranteed by the foreign bank parent, the parent will likely be considered to be issuing securities in the United States as well. Section 2(a)(36) of the Investment Company Act includes guarantees within the definition of the term security. *See* 15 U.S.C. § 80a-2(a)(36) (1982). Rule 5b-2 under the Investment Company Act provides that guarantees are not securities under certain circumstances for purposes of the diversification tests of the Investment Company Act, which indicates that the SEC's position is that generally a guarantee is deemed to be a security. *See* 17 C.F.R. § 270.5b-2 (1985). For a discussion of the securities laws applicable to securities issued by a United States subsidiary of a foreign bank, see *infra* text accompanying notes 258-301.

174. 15 U.S.C. § 80a-3(a) (1982). Banks generally do not issue face-amount certificates of the installment type. This term is defined in Section 2(a)(15) of the Investment Company Act, *infra* note 278. *See* 15 U.S.C. § 80a-2(a)(15) (1982). The term "government security" is defined at 15 U.S.C. § 80a-2(a)(16) (1982); the term "employees' securities company" is defined at 15 U.S.C. § 80a-2(a)(13) (1982); and the term "majority-owned subsidiary" is defined at 15 U.S.C. § 80a-2(a)(24) (1982), *infra* note 201.

company. Under the wording of Sections 3(a)(1) and 3(a)(3), it is not clear whether a foreign bank should be viewed as an investment company.

(A) *The SEC Position*

Based on the assumption, discussed in subsection (B) below, that loan portfolio assets are securities for purposes of the Investment Company Act, the SEC has adopted the position that foreign banks are investment companies for purposes of the Investment Company Act.[175] In the past, the SEC has had difficulty determining whether a foreign bank falls within Section 3(a)(1), as an entity "engaged primarily . . . in the business of investing, reinvesting, or trading in securities", or Section 3(a)(3), as an entity "engaged . . . in the business of investing, reinvesting, owning, holding, or trading in securities, and owns . . . investment securities having a value exceeding 40 per centum of the value of the [foreign bank's] total assets."[176] In recent years, however, the SEC has avoided the need to decide between the two sections and has instead concluded that foreign banks are investment companies under both sections.[177]

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175. The most explicit statement by the SEC of its position that foreign banks are investment companies is contained in a 1982 release, SEC Investment Co. Act Release No. 12,679, 47 Fed. Reg. 42,578 (1982), *reprinted in* [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶83,256 at 85,319, 85,322-23 n.17 (available Sept. 22, 1982).

176. For example, a number of successful foreign bank applicants for exemptions from all the provisions of the Investment Company Act pursuant to Section 6(c) of the Investment Company Act, 15 U.S.C. § 80a-6(c) (1982), based their applications solely on the basis that the applicants as issuers in the business of "investing, reinvesting, owning, holding, or trading in securities" and having over 40 percent of their assets in investment securities, might be investment companies under Section 3(a)(3). *See, e.g., In re* Skandinaviska Enskilda Banken, SEC Investment Co. Act Release No. 10,817, 18 S.E.C. Docket 41 (Aug. 7, 1979) (order); SEC Investment Co. Act Release No. 10,770, 17 S.E.C. Docket 1283 (July 9, 1979) (notice of filing); *In re* Banque Nationale de Paris, SEC Investment Co. Act Release No. 10,813, 18 S.E.C. Docket 38 (Aug. 7, 1979) (order); SEC Investment Co. Act No. 10,767, 17 S.E.C. Docket 1278 (July 9, 1979) (notice of filing). *See* discussion of Section 6(c) exemption, *infra* notes 239-48 and accompanying text. For example, in *Skandinaviska Enskilda*, the SEC, in a notice of filing published by the SEC for an order pursuant to Section 6(c) of the Investment Company Act, first set forth the definition of Section 3(a)(3) and then stated: "Applicant states that there is uncertainty whether it would be considered an investment company as defined under the [Investment Company] Act." Although the applicant had not itself mentioned that its uncertainty arose under Section 3(a)(3), the SEC chose to apply that provision.

177. For a general discussion of exemptions under Section 6(c), see *infra* notes 239-48 and 296-301 and accompanying text. In the 1982 Release, referred to in note 175, the SEC took the broad position that foreign banks, because they are not banks under Section 2(a)(5) of the Investment Company Act, are investment companies under Sections 3(a)(1) *and* 3(a)(3). The release confirms the view that the SEC is not currently willing to specify the exact theory under which foreign banks are viewed as investment companies.

By taking the position that foreign banks are investment companies under both Section 3(a)(1) and Section 3(a)(3), the SEC has, in effect, precluded foreign banks from availing themselves of the benefits of Sections 3(b)(1) and 3(b)(2) of the Investment Company Act which, as discussed below, arguably would exempt foreign banks from the definition of investment company if they were deemed to be investment companies by virtue of Section 3(a)(3) only.[178] Section 3(a)(1) of the Investment Company Act applies only if the issuer is engaged primarily in the business of investing, reinvesting, or trading in securities.[179] To the extent that a foreign bank's loan portfolio assets are deemed to be securities for purposes of determining that foreign banks are investment companies, there appears to be little basis for assuming, as the SEC apparently has, that foreign banks invest, reinvest, or trade in their loan portfolios. At best, foreign banks engage in "owning" and "holding" their loan portfolios and should be deemed to be investment companies, if at all, only on the basis of Section 3(a)(3).[180]

In support of its position that foreign banks are investment companies, the SEC contends that Congress intended foreign banks to come within the definition of an investment company, because, unlike United States banks, foreign banks were not specifically excluded from the definition.[181] The SEC argues that the specific exclusion for domestic banks in Section 3(c)(3)[182] of the Investment Company Act is evidence that Congress considered banks to be in-

178. 15 U.S.C. § 80a-3(b)(1), (2) (1982). *See infra* notes 196-203 and accompanying text.

179. *See supra* note 173 and accompanying text.

180. *See In re* International Bank, SEC Investment Co. Act Release No. 3986 (June 4, 1964), *reprinted in* [1964-66 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,101, at 82,011; *In re* Atlantic Coast Line Co., 11 S.E.C. 661, 663-64, *reprinted in* [1941-1944 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 75,289.

181. *See* Gruson & Jackson, *supra* note 61, at 185; *In re* Paribas Corp., 40 S.E.C. 487, 489 (1961), *reprinted in* [1957-1961 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,751, at 80, 847; Continental Illinois Ltd., SEC No-Action Letter (available Apr. 1, 1973), [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,338, at 83,016 [hereinafter cited as Continental Illinois Ltd.]; Swedish Inv. Bank, Ltd., SEC No-Action Letter (available Apr. 25, 1975, on LEXIS, Fedsec library, Noact file).

182. *See* 15 U.S.C. § 80a-3(c)(3) (1982); 15 U.S.C. § 80a-2(a)(5) (1982) (definition of bank). *See also infra* notes 230-38 and accompanying text; notes 367-71 and accompanying text (discussion of the applicability of Section 3(c)(3) of the Investment Company Act to United States branches and agencies of foreign banks).

vestment companies under Section 3(a).[183] The argument is not persuasive.[184]

There is substantial support for the argument that the Section 3(c)(3) exemption from the Section 3(a)(1) definition of investment company was limited to domestic banks because their operations and securities investments are governmentally supervised.[185] Such supervision guarantees that United States banks are "primarily engaged" in the banking business and so forecloses the possibility that a "sham bank" might be established to evade the requirements of the Investment Company Act. Foreign banks, on the other hand, may not always be subject to the same degree of governmental supervision as United States banks, which would explain why the Investment Company Act does not extend the blanket Section 3(c)(3) exception to those entities.[186] All that can reasonably be concluded from the limitation of Section 3(c)(3) to domestic banks is that, as contemplated by Section 3(b)(1), a case-by-case approach under that Section is appropriate with respect to foreign banks to determine whether or not they are primarily engaged in a business other than that of investing, reinvesting, owning, holding, or trading in securities.[187]

(B) *Commercial Loans as Securities*

As indicated previously, the SEC takes the position that loans are securities for purposes of determining whether or not the entities holding the loans may be investment companies for purposes of the

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183. The SEC has stated:

> The Act provides in Section 3(c) specific exceptions for various types of financial institutions, such as banks or underwriters, not deemed to be investment companies, and under ordinary rules of statutory construction, the substantive criteria for the specific exceptions contained in Section 3(c) must be applied, where a company claiming to be a bank or an underwriter seeks an exception.

In re Paribas Corp., 40 S.E.C. 487, 490 n.5 (1961).

184. *See* Gruson & Jackson, *supra* note 61, at 216.

185. Thus, Section 2(a)(5)(C) of the Investment Company Act (in conjunction with Section 3(c)(3)) explicitly allows an exemption to a banking institution "which is supervised and examined by State or Federal authority having supervision over banks," while Sections 2(a)(5)(A) and (B) implicitly incorporate a requirement of government supervision. *See* 15 U.S.C. § 80a-2(a)(5)(A)-(C) (1982). For a discussion of the possibility that foreign banks with banking subsidiaries and branches or agencies in the United States qualify as "banks" within the meaning of Section 2(a)(5)(C) of the Investment Company Act, see *infra* notes 367-71 and accompanying text.

186. For a discussion of the legislative history of Section 3(c)(3), see Gruson & Jackson, *supra* note 61, at 217 n.178.

187. This approach would be consistent with the rationale followed in *Wolf*, *supra* text accompanying notes 31-37.

Investment Company Act.[188] By claiming that loans made in the ordinary course of business are securities, the SEC is able to assert that a foreign bank's primary business is "investing, reinvesting or trading in securities," as required under Section 3(a)(1), or to assert that over 40 percent of its assets comprise investment securities, as required under Section 3(a)(3).[189] Despite the SEC's position, however, there are persuasive arguments supporting the view that commercial bank loans should not be considered securities under the Investment Company Act.

Notwithstanding the broad wording of the Investment Company Act definition of "security,"[190] it is clear that not every bank loan transaction involves a security.[191] Courts have held that even though a bank's portfolio of loans may be represented by "notes" or other "evidences of indebtedness," they need not necessarily be securities under the federal securities laws, generally on the theory that a note issued in an "investment" transaction falls within the definition of "security" in the federal securities statutes while a note issued in a "commercial" transaction does not.[192] Although the issue has most

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188. *See* SEC Investment Co. Act Release No. 12,679 (Sept. 22, 1982), 47 Fed. Reg. 42578, *reprinted in* [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,256, at 85,319, 85,323 n.17. *Cf. In re* Paribas Corp., 40 S.E.C. 487 (1961) ("investing, reinvesting, owning, holding, or trading in securities is an essential part of the activities of a bank . . ."); Continental Illinois Ltd. *supra* note 181 (foreign banks are investment companies because they are engaged in the business of investing in securities).

189. See the discussion on apparent SEC position with respect to Section 3(a) definitions, *supra* text accompanying notes 173-88.

190. The definition of the term "security" in Section 2(a)(36) of the Investment Company Act is similar to that under the Securities Act, *supra* note 25. 15 U.S.C. § 80a-2(a)(36) (1982).

191. As Judge Friendly noted: "[T]he Fifth Circuit's oft-cited dictum . . . that the 'definition of a security has been literally read by the judiciary to the extent that almost all notes are held to be securities,' has been considerably eroded, in part by that court itself." Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1134 (2d Cir. 1976) (Friendly, J.) (quoting Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 991-92 (5th Cir. 1969)) [hereinafter cited as *Touche Ross*].

192. *See, e.g.*, C.N.S. Enterprises, Inc. v. G & G Enterprises, Inc., 508 F.2d 1354, 1361 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); Zabriskie v. Lewis, 507 F.2d 546, 551 (10th Cir. 1974); Bellah v. First Nat'l Bank, 495 F.2d 1109, 1114 (5th Cir. 1974); McClure v. First Nat'l Bank, 479 F.2d 490, 495 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) ("[T]he [Securities Exchange] Act [of 1934] does not cover any *commercial* notes, no matter how long their maturity, because they fall outside the 'any note' definition of a security."). *See generally* Lipton & Katz, *"Notes" Are Not Always Securities*, 30 BUS. LAW. 763 (1975); Lipton & Katz, *Notes Are (Are Not?) Always Securities—A Review*, 29 BUS. LAW. 861 (1973). In C.N.S. Enterprises, Inc., Judge Sprecher noted that:

> In one sense every lender of money is an investor since he places his money at risk in anticipation of a profit in the form of interest. Also in a broad sense every investor lends his money to a borrower who uses it for a price and is expected to return it one day. On the other hand, the polarized extremes are conceptually identifiable: buying shares of

often arisen under statutes other than the Investment Company Act, the SEC has recognized that, for most purposes, the definition of "security" in the three major federal securities acts is coextensive.[193]

In addition, an argument can be made that commercial loans should specifically not be considered securities under the Investment Company Act because they do not give rise to the type of abuses which the Investment Company Act was designed to prevent.[194] The legislative history shows that the concerns which led Congress to pass the Investment Company Act related to "liquid, mobile and readily negotiable" pools of assets.[195] Since the commercial loan portion of a bank's portfolio is not liquid or readily negotiable, it follows that a pool of commercial loans was not of the sort designed to be regulated by the Investment Company Act.

ii. *Section 3(b) Exceptions*

Sections 3(b)(1) and 3(b)(2) of the Investment Company Act provide exceptions from the definition of investment company for entities which come within the Section 3(a)(3) definition of investment company. As noted previously, these provisions do not provide exceptions from the Investment Company Act for Section 3(a)(1) investment companies. Sections 3(b)(1) and 3(b)(2) provide that even if an issuer is engaging in the business of "investing, reinvesting, owning, holding, or trading in securities" and owns investment securities whose value exceeds 40 percent of its total assets, so that the issuer would presumptively be an investment company under Section 3(a)(3), the issuer is not an investment company if it is "(1) . . .

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the common stock of a publicly-held corporation, where the impetus for the transaction comes from the person with the money, is an investment; borrowing money from a bank to finance the purchase of an automobile, where the impetus for the transaction comes from the person who needs the money, is a loan. In between is a gray area which, in the absence of further congressional indication of intent or Supreme Court construction, has been and must be in the future subjected to case-by-case treatment.

508 F.2d at 1361 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975), *quoted with approval* by Judge Friendly in *Touche Ross*, 544 F.2d at 1135-36.

The Court of Appeals for the Ninth Circuit has applied a risk-capital test under the Securities Act and the Exchange Act to find that a promissory note given to a bank in the course of a commercial loan transaction does not bear the characteristic risk of a "security". Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1260 (9th Cir. 1976). The test used by the Second Circuit excepts from the definition of note those transactions which bear a "family resemblance" to commercial transactions. *See Touche Ross*, 544 F.2d at 1137-38.

193. *See* American Express Income Shares, Inc., SEC No-Action Letter, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,074, at 85,020 (available Dec. 3, 1974).

194. *See* Gruson & Jackson, *supra* note 61, at 209-12.

195. *Id.* at 210 (quoting S. Rep. No. 1775, 76th Cong., 3d Sess. 6 (1940)).

primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities,"[196] or if it is an issuer "(2) . . . which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar types of businesses."[197] These exclusions are intended to prevent the Investment Company Act's requirements from applying to issuers engaged in businesses not intended to be encompassed by the Investment Company Act.[198]

There are two significant differences between the Section 3(b)(1) and 3(b)(2) exceptions from the definition of investment company. First, while the exception under Section 3(b)(1) is self-executing, the exception under Section 3(b)(2) is available only pursuant to an SEC order. Second, the Section 3(b)(1) exception is available only if an issuer is primarily engaged in a non-investment company business either itself or through wholly-owned subsidiaries.[199] By contrast, the Section 3(b)(2)[200] exception is available when the issuer is primarily

196. 15 U.S.C. § 80a-3(b)(1) (1982).

197. *Id.* § 80a-3(b)(2).

198. In addition, two rules under the Investment Company Act grant exceptions to certain entities from the definition of investment company. Rule 3a-1 provides that, notwithstanding Section 3(a)(3), an issuer will not be deemed an investment company if not more than 45 percent of the issuer's total assets consist of securities (excepting government securities, securities of employees' securities companies and securities of certain subsidiaries and controlled companies of the issuer). 17 C.F.R. § 270.3a-1 (1985). *See* SEC Investment Co. Act Release No. 11,551 (Jan. 14, 1981), 46 Fed. Reg. 6,869 (1981), *reprinted in* [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,805, at 83,918. Rule 3a-2 under the Investment Company Act provides an exception for "transient" investment companies. *See* 17 C.F.R. § 270.3a-2 (1985). That rule provides that an issuer will not be deemed to be "engaged in the business of investing, reinvesting, owning, holding, or trading in securities" for up to a one-year period for purposes of Sections 3(a)(1) and 3(a)(3) so long as it has a "*bona fide* intent to be engaged primarily, as soon as is reasonably possible . . . in a business other than that of investing, reinvesting, owning, holding or trading in securities . . ." *Id.* This intent must be evidenced by the issuer's business activities and an appropriate resolution of the issuer's board of directors or similar entity. *Id.* An issuer may rely on this provision only once during any three-year period. *Id.* § 270.3a-2(c). *See* SEC Investment Co. Act Release No. 11,552 (Jan. 14, 1981), 46 Fed. Reg. 6,882 (1981), *reprinted in* [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,806, at 83,921.

199. "Wholly-owned subsidiary" of a person is defined in the Investment Company Act as "[A] company 95 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a wholly-owned subsidiary of such person." 15 U.S.C. § 80a-2(a)(43) (1982).

200. Section 3(b)(2) was included in the Investment Company Act to subject to the Investment Company Act's provisions " 'special situation companies'—companies which invest in,

engaged in a non-investment company business either itself, or through majority-owned subsidiaries[201] or controlled companies.

Logic, as well as the legislative history of the Investment Company Act, requires that the banking industry be considered a type of business intended to be excluded from the definition of investment company by Section 3(b)(1).[202] Accordingly, if foreign banks are to be viewed as Section 3(a)(3) investment companies because their commercial loans are deemed to be securities, the Section 3(b)(1) exclusion ought to be available to a foreign bank which is primarily engaged in the business of banking.[203]

iii. *Registration*

Foreign banks seeking to issue securities in the United States which do not wish to be exposed to the delays and risks of contesting the SEC position that foreign banks are investment companies may (i) seek SEC approval to register as investment companies,[204] (ii) limit their activities in the United States to those not requiring registration,[205] or (iii) obtain an exemption from the SEC from registration.[206] Registration is not an available option in practice. Even if a

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and gain control of, other companies only to rehabilitate and sell them, and not to operate them." Gruson & Jackson, *supra* note 61, at 200 n.90 (citing *Hearings before the Subcomm. on Securities and Exchange of the House Comm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 102 (1940)).

201. A "majority-owned subsidiary" of a person as defined in the Investment Company Act means "a company 50 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person." 15 U.S.C. § 80a-2(a)(24) (1982).

202.

> You are not within the purview of this legislation if you are primarily engaged in any other business even though you may have a substantial part of your assets in marketable securities . . . . [However,] I can give you instances showing that it is really doubtful what the primary business of a company is. Are they engaged in speculating in common stock on the New York Stock Exchange, or are they engaged primarily in the business of manufacturing or in the chemical industry or the banking industry?

Gruson & Jackson, *supra* note 61, at 214 (quoting *Hearings Before the Subcomm. on Securities and Exchange of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 177-78 (1940) (statement by Mr. Schenker)).

203. As stated above, the SEC has not made clear its position whether foreign banks are investment companies by virtue of Section 3(a)(1) or 3(a)(3) of the Investment Company Act.

204. *See supra* text accompanying note 172.

205. In addition, Section 3(c) of the Investment Company Act presents several exceptions from the definition of investment company. *See infra* notes 230-38 and accompanying text.

206. Under Section 6(c) of the Investment Company Act, the SEC has the authority to grant exemptions from particular provisions of the Investment Company Act, and has granted such exemptions in various instances. 15 U.S.C. § 80a-6(c) (1982). *See infra* notes 239-48 and accompanying text.

foreign bank chooses to seek registration as an investment company, which no foreign bank has yet attempted, it would encounter formidable obstacles, and even if a foreign bank succeeds in obtaining an SEC order permitting registration, it would become subject to the significant financial and operational burdens and restrictions imposed by the Investment Company Act on all registered investment companies. These include limitations on the composition of the board of directors, limitations as to permissible transactions and investments, and restrictions on distribution and repurchase of securities.[207]

Even in the case of foreign entities which operate and presumably could tolerate being regulated as investment companies, the registration route has been arduous. With the exception of Canadian companies,[208] few foreign investment companies, and none from non-common law jurisdictions, have been able to register with the SEC.[209]

The case of the Union Investment Gesellschaft,[210] a West German investment company, is particularly illustrative of the barriers to registration faced by a foreign investment company from a non-common law country. Union negotiated with the SEC for eleven years to obtain an SEC order permitting it to sell shares of its mutual fund, Unifunds, to investors in the United States. It argued that compliance with West German law, together with certain conditions consented to in its application, would satisfy the standards of Section 7(d) of the Investment Company Act.[211] When the statutorily prescribed notice of Union's application was finally published in the Federal Register, an event which generally indicates the SEC is prepared to grant the order applied for, the application was promptly challenged by the Investment Company Institute (ICI), the national trade association of the United States mutual fund industry.[212] The

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207. 15 U.S.C. §§ 80a-10, -12, -18, -22 (1982).

208. Rule 7d-1 under the Investment Company Act in 1954 specifies the conditions and arrangements under which Canadian management investment companies may register. 17 C.F.R. § 270.7d-1 (1985). No other foreign country has been the subject of such a rule to date.

209. The SEC now recommends that "any foreign investment company operating in a legal or regulatory environment which differs significantly from the [Investment Company] Act" consider the formation of a separate company to offer shares in the United States. SEC Investment Co. Act Release No. 13,691 (Dec. 23, 1983), 49 Fed. Reg. 55 (1984), *reprinted in* 4 FED. SEC. L. REP. (CCH) ¶ 47,662, at 36,614 [hereinafter cited as Section 7(d) Release]. *See infra* notes 218-19 and accompanying text.

210. Union-Investment-Gesellschaft was one of the largest investment companies in West Germany, managing at the time $1.8 billion of assets. *See* SEC. REG. & L. REP. (BNA) 1338 (July 15, 1983).

211. 15 U.S.C. § 80a-7(d) (1982). *See supra* text accompanying note 172.

212. The Investment Company Institute (ICI) challenged the application by filing a request for a full hearing before the SEC on the matter. For a discussion of the procedure by which

SEC then ordered a full evidentiary hearing, raising the likelihood of considerable further delays.[213] At that point, Union abandoned its effort to register as an investment company with the SEC.[214]

Union's application and the ICI's request for a hearing demonstrate the practical difficulties associated with an attempt by a foreign investment company to comply with the standards mandated by Section 7(d). For example, a West German law prohibiting persons managing a mutual fund from being liable to the shareholders conflicted with the liability provisions of the Investment Company Act.[215] Union also argued that providing duplicates of Union's records for inspection in the United States, in compliance with the Investment Company Act,[216] would be too expensive and impractical.[217] In addition, it was unclear whether, under West German law, it would be possible for the fund's United States investors to assert jurisdiction over Union's management or assets.

Partially as a consequence of Union's experience, in 1983 the SEC issued a release setting forth its views regarding the plight of foreign investment companies seeking to publicly offer their shares in the United States.[218] The SEC recommended that any foreign investment company from a civil law country wishing to do business in the United States set up a separate United States "mirror company" or subsidiary.[219] While recommending legislation to Congress to sim-

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applications are filed and orders granted by the SEC, see *infra* notes 242-48 and accompanying text.

213. The seemingly endless procedure facing Union was described as follows: "[a]n opinion must be issued by an administrative law judge, which can be appealed to the full commission. Whatever decision is made by the commission could then be challenged in the courts, which could take several more years." SEC. REG. & L. REP. (BNA) 922 (May 13, 1983).

214. In a public statement, Union expressed indignation at the fact that the SEC, its staff, and the ICI had each encouraged it during the past years, only to then block the application. SEC. REG. & L. REP. (BNA) 1338 (July 15, 1983).

215. *See* 15 U.S.C. § 80a-35 (1982).

216. *See id.* § 80a-30.

217. In an effort to surmount the jurisdictional problems, Union proposed to maintain an irrevocable letter of credit in the United States payable to any person who obtained an unsatisfied judgement against Union. As a result of these and other problems, Union's application to register also contained a request for Section 6(c) exemption from various provisions of the Investment Company Act.

218. *See supra* note 209.

219. SEC Investment Co. Act Release No. 13,691 (Dec. 23, 1983), 49 Fed. Reg. 55 (1984), *reprinted in* 4 FED. SEC. L. REP. (CCH) ¶ 47,662, at 36,616. As an example of such a circumstance, in 1983, dual investment companies were set up by its sponsors, one within the United States and one outside. The two entities had similar investment objectives and parallel distribution arrangements, but of course only the United States entity was permitted to offer its shares within the United States. The United States entity, Sci-Tech, Inc., became registered with the SEC in 1983.

plify the task of a foreign investment company wishing to register with the SEC, the release in effect conceded that the obstacles presented by the existing Section 7(d) registration process effectively preclude an investment company domiciled in a non-common law jurisdiction from registering under the Investment Company Act.

The magnitude of the difficulty facing a foreign bank seeking to offer its securities in the United States is thus clear. If it is an investment company, it can engage in a public offering only if registered with the SEC under the Investment Company Act. The SEC argues that a foreign bank is an investment company but has also recognized that, as a practical matter, a foreign bank will be unable to register. As a result, foreign banks must either avoid offering their securities publicly or obtain exemptive relief from the requirements of the Investment Company Act to permit a public offering of securities.[220]

iv. *Private Offering*

Although Section 7(d) prohibits a foreign investment company from engaging in a public offering unless it is registered with the SEC, the avenue of a private placement is still open to it. In that respect, the treatment of foreign investment companies under the Investment Company Act differs from the treatment of domestic investment companies, which are prohibited from issuing any securities (whether or not in a public offering) unless the companies are registered with the SEC. A foreign bank or its foreign finance subsidiary (but not its United States subsidiary) therefore may engage in a private placement in the United States without registering under the Investment Company Act or obtaining an exemption from the SEC.[221]

The term "public offering" in the Investment Company Act has been interpreted by the SEC to have the same meaning as under Section 4(2) of the Securities Act.[222] The SEC has stated that, for purposes of the Investment Company Act, the provisions of Regulation D under the Securities Act will be applicable as well, so that

220. The story of Svenska Handelsbanken's attempt to become the first foreign bank to offer its commercial paper in the United States is illustrative. *See* Gruson & Jackson, *supra* note 61, at 185-86 (citing AM. BANKER, Sept. 8, 1978, at 1), 220-21.

221. A United States finance subsidiary could, however, rely on the Section 3(c)(1) exception from the definition of investment company. *See infra* text accompanying notes 268-75.

222. *See* 15 U.S.C. § 77d(2) (1982). *See also supra* text accompanying notes 75-101.

compliance with its provisions will result in a safe harbor under both the Securities Act and the Investment Company Act.[223]

In a 1984 no-action letter to Touche, Remnant & Co., the SEC staff advanced the position that a foreign investment company contemplating a non-public offering in the United States in reliance on Section 7(d) of the Investment Company Act must also comply with the additional limitations contained in Section 3(c)(1).[224] That section excepts from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are owned by fewer than 100 persons and who is not making a public offering.[225] The SEC staff position would limit the alternative of a private offering in the United States to foreign investment companies with fewer than 100 beneficial owners in the United States.[226]

The SEC staff's stated concern is that any different result would provide inconsistent treatment of domestic and foreign investment companies contrary to legislative intent.[227] The SEC staff's position, however, conflicts with the wording of Section 7(d), which provides no statutory authority to require foreign investment companies to register under the Investment Company Act unless such companies utilize the mails or any means or instrumentality of commerce "in connection with a public offering."[228] The legislative history relied on

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223. *See* Continental Bank, SEC No-Action Letter, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,248, at 78,081 (available Sept. 2, 1982). For a discussion of Rule 506 under the Securities Act, *see supra* notes 102-33 and accompanying text.

224. Touche, Remnant & Co. (U.K.), Stein Roe & Farnham, SEC No-Action Letter (available Aug. 27, 1984, on Lexis, Fedsec library, Noact file [hereinafter cited as Touche, Remnant].).

225. For a general discussion of the Section 3(c)(1) exception, see *infra* text accompanying notes 268-75.

226. *See infra* notes 268-72 and accompanying text.

227. In Touche, Remnant & Co., *supra* note 224, the SEC staff stated that:

> Section 7(d) demonstrates Congress' intent to require foreign investment companies whose conduct has a significant effect on U.S. investors to be subject to the same type of regulation that applies to American investment companies. Reading Section 7(d) in the light of that policy, and the policy expressed in Section 3(c)(1), we conclude that where a foreign investment company uses jurisdictional means in connection with an offer of its securities to U.S. residents, which offer results in the company having more than 100 beneficial owners resident in the U.S., such a company may not sell its securities to U.S. residents without fully complying with the [Investment Company] Act. If Section 7(d) were not interpreted in this manner, U.S. investment companies with more than 100 beneficial owners would be subject to regulation under the [Investment Company] Act while foreign investment companies with more than 100 beneficial owners resident in the U.S. would not be so regulated. We believe such a result would be contrary to the policy expressed in Section 7(d).

Id. (citations omitted).

228. 15 U.S.C. § 80a-7(d) (1982).

by the SEC staff provides no basis for any interpretation of the statute contrary to its plain meaning.[229] As a result, the position taken by the staff in the Touche, Remnant letter appears to be inconsistent with the treatment of foreign investment companies contemplated by Congress.

v. *Section 3(c) Exceptions*

Although "investment company" is broadly defined under Section 3(a) of the Investment Company Act, Section 3(c) of the Investment Company Act contains a number of exceptions excluding certain issuers not intended to be regulated by the Investment Company Act from the Section 3(a) definition.[230] A foreign bank may therefore wish to explore its ability to come within one or more of the exceptions. Unlike Section 3(b), the exceptions set forth in Section 3(c) exclude issuers from the definition of "investment company" regardless of the particular provision of Section 3(a) which applies to them.[231]

Although the Section 3(c) exceptions are of particular relevance to United States subsidiaries of foreign banks,[232] Section 3(c)(3), which provides an exception for "any bank," and Section 3(c)(5), which provides an exception for purchases of notes and mortgages and for certain other lenders, also have some relevance to foreign banks themselves. First, as discussed below, foreign banks have in the past obtained no-action positions from the SEC staff that they came

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229. In its response to the Touche Remnant & Co. letter, *supra* note 224, the SEC staff stated:

> It is the purpose of Section 7(d) that "foreign investment companies may not register as investment companies or publicly offer securities of which they are the issuer in the United States unless the Commission finds that these foreign investment companies can be effectively subjected to the same type of regulation as domestic investment companies. S. Rep. No. 1775, 76th Cong., 3d Sess. 13 (1940).

Id. at n.2.

230. Sections 3(c)(1) through 3(c)(13) of the Investment Company Act list the various available exceptions from the definition of investment company. 15 U.S.C. § 80a-3(c)(1) to (13) (1982). See *infra* general discussion in text accompanying notes 268-294.

In addition to the exceptions discussed in the text, exceptions exist for companies that are: subject to regulation under the Interstate Commerce Act (Section 3(c)(7)), registered under the Public Utility Holding Company Act (Section 3(c)(8)), in the business of holding royalties, and leases and fractional interests (Section 3(c)(9)), operated for religious, educational or similar purposes (Section 3(c)(10)), pension plans (Section 3(c)(11)), voting trusts (Section 3(c)(12)), and securities holders' "protective committees" (Section 3(c)(13)). *Id.*

231. Compare Section 3(b) of the Investment Company Act, which excludes issuers *only* from the Section 3(a)(3) definition of investment company. *Id.* § 80a-3(b).

232. For a general discussion of Section 3(c) of the Investment Company Act, see *infra* text accompanying notes 268-75.

within the definition of "bank" contained in Section 2(a)(5) of the Investment Company Act by virtue of being supervised within the United States through its United States branch or agency.[233]

Second, Section 3(c)(3) also excludes "savings and loan association[s], building and loan association[s], . . . homestead association[s], [and] similar institution[s]" from the definition of "investment company."[234] Unlike the term "bank," those terms are not defined in the Investment Company Act, a circumstance which leaves open the possibility that a savings and loan, building and loan, or homestead association organized under the laws of a jurisdiction other than the United States might be excluded from the definition of investment company under Section 3(c)(3).[235]

Third, some foreign investment banks have received SEC no-action letters under Section 3(c)(5)(B) of the Investment Company Act,[236] which provides an exception for issuers primarily engaged in making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance and services.[237] The SEC has indicated, however, that it is disinclined to grant further no-action letters to foreign investment banks based on Section 3(c)(5)(B) and has instead suggested that a foreign investment bank consider seeking an SEC order pursuant to Section 6(c)

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233. See discussion of Bank Leumi le-Israel B.M., SEC No-Action Letter (available Aug. 27, 1976, on LEXIS, Fedsec library, Noact file) and Israel Discount Bank Ltd., SEC No-Action Letter (available Mar. 2, 1974, on LEXIS, Fedsec library, Noact file), *infra* note 371 and accompanying text.

234. 15 U.S.C. § 80a-3(c)(3) (1982).

235. The SEC, however, might exercise its authority to define statutory terms by rule to prevent any foreign entity from relying on this theory.

236. *See* Banque Francaise du Commerce Exterieur, SEC No-Action Letter (available June 26, 1975, on LEXIS, Fedsec library, Noact file) (bank relied on 3(c)(5)(A) and (B)); Swedish Investment Bank, SEC No-Action Letter (available Apr. 25, 1975, on LEXIS, Fedsec library, Noact file). Development Finance Corp. of New Zealand, SEC No-Action Letter, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,036, at 81,640 [hereinafter cited as Development Finance Corp.] (available Jan. 27, 1979). In the Development Finance Corp. letter, the SEC staff stated that it would not recommend enforcement action if the applicant, an entity wholly owned by the New Zealand government, issued and sold short-term promissory notes in the United States without registering under the Investment Company Act. The applicant was established by the New Zealand government to make loans, for the purpose of developing New Zealand industry, to New Zealand companies engaged in manufacturing, processing, fishing, transportation or related service industries. The SEC staff apparently granted the request under Section 3(c)(5)(B), emphasizing that its position was based on the understanding that loans were made by the applicant only for the purpose of developing New Zealand industry and was conditioned on the maintenance by the New Zealand government of its 100 percent ownership of the applicant's securities.

237. For a discussion of Section 3(c)(5)(B) in connection with United States finance subsidiaries of foreign banks, see *infra* notes 283-85 and accompanying text.

of the Investment Company Act if it wishes to resolve any uncertainty concerning its status under the Investment Company Act.[238]

vi. Section 6(c) Exemption

In view of the uncertainties concerning the status of foreign banks under the Investment Company Act, a number of foreign banks have sought and received exemptions under Section 6(c) of the Investment Company Act, which grants the SEC broad authority to exempt any issuer from any or all provisions of the Investment Company Act if such exemption is found to be: (i) in the public interest, (ii) consistent with the protection of investors, and (iii) consistent with the purposes of the Investment Company Act.[239] The SEC has granted numerous Section 6(c) exemptions to entities, including foreign banks and their subsidiaries, which it believes do not pose risks to the investing public or lend themselves to the abuses against which the Investment Company Act was directed.[240]

Foreign banks typically apply for exemptions pursuant to Section 6(c) in three situations. First, if the foreign bank were seeking to issue its own debt securities[241] in the United States, the foreign bank would seek an exemption for itself. Second, if a foreign bank intended to guarantee securities to be issued by a United States subsidiary, the SEC would require the subsidiary and the foreign bank

238. Australian Indus. Dev. Corp., SEC No-Action Letter, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,745 at 77,063, 77,065 (available Aug. 11, 1980).

239. 15 U.S.C. § 80a-6(c) (1982).

240. *See supra* note 16. The procedure for obtaining an exemption pursuant to Section 6(c) under the Investment Company Act is set forth in rules promulgated by the SEC. 17 C.F.R. § 270.0-1 to 0-10 (1985). The exemption application, which may be made individually or, in cases involving securities issued by a United States subsidiary of the foreign bank that are guaranteed by the foreign bank, jointly by the foreign bank parent and its subsidiary, must state the grounds for the requested exemption as well as the provisions of the Investment Company Act under which the application is made.

Following review by the SEC staff of the application and any amendments filed, the SEC publishes a notice of the application in the Federal Register. *See id.* § 270.0-2(g). The notice consists of a brief summary of the application as well as notification of the earliest day on which an order may be issued. Generally, the order date is approximately 30 days from the date of the notice. Following the notice, any interested person may submit additional facts or request that a hearing be held on the application. *Id.* § 270.0-5(a). The SEC has discretion to order a hearing either on its own motion or upon the request of an interested person if doing so would be necessary or appropriate in the public interest. See the discussion of Union's attempt to register under the Investment Company Act, *supra* notes 210-14 and accompanying text. Hearings are generally held in cases involving significant novel issues.

241. All Section 6(c) exemptions issued by the SEC to date to foreign banks and their United States subsidiaries have involved the offering of debt securities. However, see *supra* note 16 and accompanying text for discussion of recent applications made by three foreign banking organizations with respect to the issuance of equity securities.

to seek an exemption because the guarantee would be considered a security separate from the subsidiary's security.[242]

Finally, even if the foreign bank does not guarantee the securities to be issued by its subsidiary, the SEC requiries both parent and subsidiary to be parties to the application if one of the purposes of the proposed offering is to provide funding for the foreign bank parent.

The SEC has issued Section 6(c) orders exempting foreign banks from all provisions of the Investment Company Act on a case-by-case basis.[243] The SEC generally requires extensive detail with respect to the operation of foreign banks applying for a Section 6(c) exemption particularly in the case of the first application from a particular jurisdiction. Successful Section 6(c) applications by foreign banks have usually contained descriptions of the bank and its business,[244] the governmental regulation to which the bank is subject in its home jurisdiction,[245] the proposed transaction[246] and any future transactions contemplated by the bank,[247] and a request for an order of the SEC, including the reasons why such an order is in the public interest, why it is consistent with investor protection and why it is consistent with the policy and provisions of the Investment Company Act.

Foreign banks that have received exemptions from the SEC have generally made the following undertakings in their applications: (i) to provide investors with information about the issuer comparable to the information generally provided purchasers of similar debt securities in the United States, accompanied by audited financial state-

242. For a discussion of a guarantee as a security, see *supra* note 173.

243. *See, e.g., In re* Credit Lyonnais Canada, SEC Investment Co. Act Release No. 13,751, 29 S.E.C. Docket 983 (Feb. 6, 1984) (order); SEC Investment Co. Act Release No. 13,711, 49 Fed. Reg. 1954 (Jan. 10, 1984) (notice of filing); *In re* Mercantile Bank of Canada, SEC Investment Co. Act Release No. 13,570, 28 S.E.C. Docket 1379 (Oct. 12, 1983) (order); SEC Investment Co. Act Release No. 13,497, 48 Fed. Reg. 42885 (Sept. 12, 1983) (notice of filing). The exemptive orders are issued by the SEC staff pursuant to authority delegated to it by the Commission.

244. The description usually includes when the bank was founded, the source of its capital, its size relative to other banks in its jurisdiction, its total assets and liabilities, the nature and extent of its international operations, and a description of the types of business in which it is engaged.

245. The description usually covers regulations applicable to the foreign bank's equity capital, loans, foreign exchange activities, and securities investments.

246. This usually includes a description of the security itself, its compliance with or exemption from the provisions of the Securities Act, the manner of offering, and the information which will be made available to each offeree.

247. The description usually includes assurances that any undertakings agreed to in connection with the proposed transaction will be complied with in such future transactions.

ments of the issuer and an explanation of any material differences between United States generally accepted accounting principles and those under which the statements were prepared; and (ii) to ensure that the securities (except those issued in a private placement) will have received one of the highest ratings from a national rating agency.[248]

d. *The Trust Indenture Act*

The Trust Indenture Act imposes special requirements on certain offerings in the United States of debt securities and guarantees of debt securities. The statute requires that, absent an available exemption, the securities must be issued pursuant to an indenture and a trustee must be provided to enforce the rights and protect the interests of investors. The statute also establishes requirements for the trustee's eligibility and duties, including requirements that the trustee be independent of the issuer and of the underwriter of the securities and that at least one trustee under the indenture be organized and doing business in the United States.[249] Procedures in the event of default under the indenture and reporting requirements, both with the SEC and with security holders, also are contained in the Trust Indenture Act.

Exemptions from the Trust Indenture Act generally are coextensive with those of the Securities Act discussed above.[250] Although Section 304(d) gives the SEC the authority to exempt, by order, any security issued by a foreign issuer, this power is not often used.[251]

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248. *See infra* notes 570-78 and accompanying text. In addition, the SEC generally requires a number of other undertakings, such as the appointment of a United States agent for service of process with respect to accepting jurisdiction in the United States, and an opinion of counsel as to the availability of an exemption under the Securities Act. Although the SEC has not to date promulgated a general exemptive rule under the Investment Company Act applicable to foreign banks, it has adopted Rule 3a-5 under the Investment Company Act exempting certain finance subsidiaries of certain foreign private issuers other than foreign banks. *See infra* notes 299-300 and accompanying text.

249. *See* Trust Indenture Act, §§ 310(a)(1), 310(b), 15 U.S.C. § 77jjj(a)(1), (b) (1982).

250. 15 U.S.C. § 77ddd(a)(4), (b) (1982).

251. *Id.* § 77ddd(d). Any note, bond, debenture, or evidence of indebtedness issued or guaranteed by a foreign government or by a subdivision, department, municipality, agency, or instrumentality thereof, which may include a foreign bank owned by a foreign government and carrying out a governmental function, is exempt from the provisions of the Trust Indenture Act pursuant to Section 304(a)(6). *Id.* § 77ddd(a)(6). *See* Israel Bank of Agriculture, Ltd., SEC No-Action Letter, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,592, at 80,384 (available Apr. 14, 1978).

B. *Securities Issued by a United States Subsidiary of a Foreign Bank*

In lieu of issuing securities directly in the United States, a foreign bank may utilize a United States subsidiary to issue debt or equity securities in the United States, the proceeds of which may be used to support the subsidiary's United States operations or the parent's overall operations.[252] Alternatively, a foreign bank may wish to establish a minimally capitalized finance subsidiary in the United States to raise capital for the foreign bank by issuing debt securities.[253]

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252. If a foreign bank has banking operations in the United States, the activities of its nonbanking operating subsidiaries in the United States will be restricted by federal banking laws. *See generally* the International Banking Act of 1978, as amended. 12 U.S.C. § 3101 *et seq.* (1982) [hereinafter cited as International Banking Act].

253. This article generally deals only with United States finance and other nonbanking subsidiaries of a foreign bank. Although a foreign bank might utilize a foreign subsidiary to issue securities in the United States, the foreign subsidiary generally will be subject to the same legal requirements in the United States as would the foreign bank itself, with the exception of the Investment Company Act, which, depending on its activities, might not apply to a nonbanking subsidiary. *See supra* text accompanying notes 266-301. Foreign banks also might establish United States subsidiaries engaged in banking activities in the United States. Although the subject of banking entities which may be established by a foreign bank is beyond the scope of this article, a brief analysis of one particular banking entity that foreign banks may establish in the United States is appropriate.

Several foreign banks have established New York investment companies, organized under Article XII of the New York Banking Law. N.Y. BANKING LAW §§ 508-520 (McKinney 1971). The term "investment company" is somewhat of a misnomer because Article XII companies more closely resemble banks than they do investment companies. Under Article XII of the New York Banking Law, Article XII companies are granted specific powers and are specifically denied certain powers. *See id.* §§ 508, 509. An Article XII company is empowered by state law to engage in the following activities:

Commercial Lending. An Article XII company may engage in commercial lending activities and, in connection with such activities, may, among other things, discount notes, drafts and bankers' acceptances and collect drafts and other commercial items. An Article XII company may also issue and confirm documentary letters of credit and stand-by letters of credit for the account of its customers. *Id.* § 508(1), (2).

Funding Activities. Because an Article XII company has the authority to borrow funds, it is authorized to issue, for example, large denomination debt obligations, such as commercial paper, to fund its activities. *Id.*

An Article XII company may not receive deposits in New York, the only major restriction to its commercial banking powers. *Id.* § 509(4). However, an Article XII company may receive "credit balances" which are incidental to the conduct of its lawful activities. *Id.* Generally, a credit balance is a deposit which is made in connection with the business being conducted by an Article XII company and its customers. Some examples of credit balances would be a compensating balance maintained by a particular customer in connection with a loan made by the Article XII company to such a customer, amounts deposited by a customer of an Article XII company to "fund" a letter of credit to be issued by the Article XII company for the account of such customer or proceeds of collections of notes or checks made on behalf of a customer by an Article XII company.

With the prior approval of the New York Banking Board, an Article XII company may accept deposits outside of New York, for instance at an off-shore branch, subject to the laws of

There are certain advantages to be gained from utilizing a United States subsidiary to issue debt in the United States rather than having the foreign bank issue such securities directly. By utilizing a

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the jurisdiction in which it seeks to receive deposits. However, the New York Banking Board has to date only approved receipt of deposits from persons outside of the United States and not from persons located in the United States outside of the State of New York. In addition, even if an Article XII company were given approval by the Department to accept deposits from persons located in the United States outside of New York, many states in the United States have unauthorized banking statutes that may prohibit such deposit taking. *See, e.g.*, CAL. FIN. CODE § 102 (West Supp. 1983).

Transmission of Money. With the approval of the New York Banking Board, an Article XII company may receive money for transmission from correspondent banks and transmit money from the United States to any foreign country and from any foreign country to the United States. N.Y. BANKING LAW § 508(3)(c) (McKinney 1971).

Securities Brokerage. An Article XII company is authorized to purchase both debt securities as well as equity securities. *See id.* §§ 508(1), 508(5). It would thus appear that an Article XII company will be permitted to purchase and sell these securities for the account of its customers.

Securities Underwriting. An Article XII company is permitted to purchase and sell for its own account securities issued by corporations. Because an Article XII company is permitted to engage in the purchasing and selling of such securities, it is arguable that an Article XII company is authorized to engage in the underwriting of such securities. Because, however, Article XII companies are not specifically authorized to engage in underwriting activities under the New York Banking Law, it is advisable that they seek the approval of the New York Banking Board prior to commencing underwriting activities.

Financial Agent of the United States. Subject to the prior approval of the New York Banking Board, an Article XII company may act as financial agent of the United States, including acting as issuing and paying agent for certain obligations issued by the United States government and accepting deposits from the United States government. *Id.* § 508(3)(a) (McKinney 1971).

Under the International Banking Act and the legislative history relating thereto, an Article XII company would be viewed as a "commercial lending company." S. Rep. No. 1073, 95th Cong., 2d Sess. 3, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 1421, 1423. The term commercial lending company is defined as "any institution . . . organized under the laws of any State of the United States, or the District of Columbia which maintains credit balances incidental to or arising out of the exercise of banking powers and engages in the business of making commercial loans. . . ." 12 U.S.C. § 3101(9) (1982). Pursuant to the International Banking Act, any foreign bank controlling directly or indirectly a commercial lending company would, among other things, become subject to the restrictions on nonbanking activities imposed by the Bank Holding Company Act of 1956, as amended, [hereinafter cited as Bank Holding Company Act]. 12 U.S.C. § 3106(a) (1982). As a result, it appears that the activities in which such an Article XII company would be authorized to engage must be consistent with the Bank Holding Company Act as well as with Article XII of the New York Banking Law. While a discussion of permissible activities for bank holding companies is beyond the scope of this article, it is clear that certain activities in which an Article XII company would be authorized to engage under New York Banking Law would not necessarily be permissible under the Bank Holding Company Act. For example, although Article XII companies are permitted to purchase equity securities for their own account under New York law, a bank holding company is severely restricted on the types of equity securities it may own. Generally, a bank holding company is not permitted to own shares of entities which are not banks unless such shares are eligible for the limited exemptions set forth in Section 4 of the Bank Holding Company Act. *See id.* § 1843(a), (c).

United States domestic entity as the issuer of the securities, the foreign bank may be able to increase its investor base to include United States institutional investors who might be restricted from purchasing securities of foreign issuers.[254] If a foreign bank issues debt securities in the United States directly, payments made to the securities holders by the foreign bank in respect of the securities may be subject to foreign withholding tax.[255]

The securities of a subsidiary may be issued on the basis of the subsidiary's own creditworthiness or in reliance on the credit support of the parent or other issuer. On the other hand, since a finance subsidiary typically would be minimally capitalized and would have only a minimum amount of assets, investors most likely would not be willing to rely solely on the creditworthiness of the finance subsidiary for payment of the finance subsidiary's obligations. As a result, a finance subsidiary's obligations typically must be supported by a guarantee or similar type of credit support of the parent bank or other creditworthy entity.[256]

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254. *See infra* notes 591-96 and accompanying text.

255. *See infra* notes 479-84 and accompanying text.

256. Credit support of a subsidiary's debt obligations may take several forms. For example, the parent foreign bank may choose to unconditionally guarantee payment of the subsidiary's debt securities, which is the customary approach. Alternatively, it is possible that the parent foreign bank could issue a letter of credit which could be drawn on in the event the holder of a debt security issued by a subsidiary of the foreign bank did not receive payments when due in respect of the debt security. The letter of credit may be "attached" to each debt security issued by the subsidiary, enabling the holder of the debt security to draw under the letter of credit in the event that the holder does not receive payments when due in respect of the debt security. Alternatively, the parent foreign bank may choose to issue a "master" letter of credit to a trustee or paying agent for the benefit of all of the holders of debt securities. Under a master letter of credit, the trustee or paying agent typically would be authorized to draw upon the master letter of credit in the event a holder of a debt security did not receive payments on the securities when due.

Another form of credit support for a subsidiary's debt securities which may be used by the parent foreign bank is a "keepwell" or support arrangement. A keepwell or support arrangement can generally be defined as an agreement between the parent foreign bank and its subsidiary which provides that the parent foreign bank would be obligated to ensure that the subsidiary has sufficient funds to meet all of its obligations, including its obligations in connection with a particular issuance of debt securities.

A keepwell or support arrangement differs from a guarantee in several respects. First, a keepwell or support arrangement entered into by a parent corporation and its subsidiary typically would not run directly to the benefit of the holders of obligations issued by the subsidiary, whereas a guarantee by the parent of certain obligations of the subsidiary would typically run directly between the parent and the holder of the relevant obligations. It should be noted, however, that the subsidiary's right to enforce the keepwell arrangement against the parent could be assigned to the holders of debt securities issued by the subsidiary, thereby giving the holders of the debt securities direct rights against the parent. Alternatively, the keepwell or support arrangement could expressly provide for a direct right of action against the parent by holders of debt securities issued by the subsidiary. Even absent an assignment or an express

The applicability of the federal securities laws to securities issued by a United States nonbanking subsidiary of a foreign bank and to any credit support provided in connection with the subsidiary's securities is discussed below. In addition, certain federal banking law considerations, which are relevant in the event that the proceeds from an offering of the subsidiary's securities are loaned or otherwise provided to a United States branch or agency of the foreign parent, are addressed below. Various state securities law, federal tax considerations, and marketability concerns are also discussed.[257]

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right, an argument can be made that investors relying on the keepwell arrangement should have rights against the parent. Second, a guarantee typically relates to a specific obligation or a series of specific obligations. On the other hand, a keepwell arrangement typically is broadly drafted and covers all obligations of a subsidiary.

Of course, the necessary credit support to be utilized in connection with the issuance of debt securities by a finance or other subsidiary of a foreign bank need not derive from the parent foreign bank. The United States branch or agency of the foreign bank may issue a letter of credit in support of the subsidiary's securities. However, the obligation on the letter of credit would be a reservable obligation in the view of the staff of the Federal Reserve Board. *See infra* note 380 and accompanying text. Alternatively, an entity unaffiliated with the foreign bank may issue a guarantee or letter of credit to provide credit support for the securities issued by a subsidiary or may enter into a keepwell arrangement with the subsidiary in connection with the obligations of the subsidiary.

257. In addition, foreign banks which establish a United States subsidiary may become subject to certain informational reporting requirements promulgated by the United States Department of Commerce, Bureau of Economic Analysis [hereinafter cited as the BEA] by virtue of authority granted under the International Investment Survey Act of 1976. 22 U.S.C. §§ 3101-3108 (1982) [hereinafter cited as IISA]. The provisions of the IISA and the regulations promulgated thereunder mandate the filing of certain reports by a United States "business enterprise" when a foreign person acquires at least a 10 percent voting interest in such business enterprise. The term "business enterprise" is defined to include "any organization, association, branch, or venture which exists for profitmaking purposes or to otherwise secure economic advantage. . . ." *Id.* § 3102(6). The definition of business enterprise would clearly include a separately incorporated financing or other subsidiary.

The IISA and the regulations and forms promulgated thereunder indicate that the purpose of the reporting requirements is to obtain accurate and comprehensive information concerning foreign investment in the United States which may affect the economic welfare of the United States. The IISA and the related regulations and forms provide that information collected thereunder may be used only by United States government officials solely for analytical and statistical purposes and for enforcement proceedings under the IISA. It is further stated that such information may not be used for the purposes of taxation, investigation or regulation. In addition, copies of the reports which are maintained in the reporting entity's files are expressly immune from legal process.

The BEA has promulgated a number of different reporting requirements which may be applicable to a financing or other subsidiary of a foreign bank. Under the IISA, certain of the reporting requirements do not become effective with respect to an entity until that entity's assets, sales or net income exceed a threshold amount. Such threshold amounts vary according to the articular reporting requirement.

1. *The Federal Securities Laws*
   a. *The Securities Act*

As with offerings of securities by foreign banks, the Securities Act requires that, absent an available exemption, securities offered in the United States by a United States subsidiary of a foreign bank be offered and sold only pursuant to a registration statement filed with the SEC. Because a subsidiary that is a United States company does not qualify as a foreign private issuer, the subsidiary is required to register its securities on one of the registration forms for domestic issuers, except as discussed below.[258]

If a subsidiary's securities are guaranteed by a foreign bank, the guarantee is a separate security as defined by Section 2(1) of the Securities Act.[259] Accordingly, unless exemptions are available, both the guarantee issued by the foreign parent and the securities issued by the subsidiary must be registered under the Securities Act. In this event, however, both the guarantee and the underlying securities may be registered simultaneously on one of the registration forms available to foreign private issuers, which are discussed in more detail below.

A United States subsidiary of a foreign bank generally may utilize the same exemptions from the registration requirements of the Securities Act as may its parent.[260] As discussed above, there are three principal exemptions the subsidiary may wish to rely on. First, the subsidiary's short-term notes may qualify for the exemption provided in Section 3(a)(3) of the Securities Act if the notes (i) do not have a maturity at the time of issuance exceeding nine months, (ii) arise out of a current transaction or the proceeds are used for a current transaction, and (iii) satisfy the additional regulatory standards established by the SEC.[261] Second, the subsidiary's securities may be ex-

258. A discussion of the forms for domestic issuers is beyond the scope of this article. However, it is noteworthy that Form S-1, the basic Securities Act registration form for domestic issuers, requires information about the issuer and its management (including audited financial statements) and about the offering transaction that is similar to, but somewhat more extensive than, the information required by Form F-1, the basic Securities Act registration form for foreign private issuers. For a discussion of Form F-1, see *infra* notes 398-403.

259. *See supra* notes 25 and 167.

260. For a discussion of comparable exemptions from the provisions of the Trust Indenture Act, see *supra* text accompanying notes 249-51.

261. *See supra* text accompanying notes 58-68. In addition, no-action letters issued by the SEC staff suggest that a guarantee of the subsidiary's short-term paper by the parent foreign bank is exempt pursuant to Section 3(a)(3) of the Securities Act. The SEC staff on occasion has taken positions that administratively permit a parent corporation to guarantee the Section 3(a)(3) exempt commercial paper of its wholly-owned subsidiary without registration pursuant to the same exemption. *See, e.g.*, U.S. Pioneer Electronics Corp., SEC No-Action Letter

empt from the registration requirements of the Securities Act if they are fully guaranteed by a United States bank (which, as discussed below, may include a United States branch or agency of the subsidiary's foreign bank parent) within the meaning of Section 3(a)(2) of the Securities Act.[262] In addition, neither the subsidiary's securities nor any supporting guarantee need be registered under the Securities Act if they are offered and sold pursuant to the private placement exemptions contained in Section 4(2) of the Securities Act or Regulation D thereunder, provided, among other things, information about both the guarantor and the subsidiary is made available to purchasers of the subsidiary's securities.[263]

b. *The Exchange Act*

As discussed above, Section 12 of the Exchange Act requires that, absent an exemption, a United States subsidiary of a foreign bank must register its securities under the Exchange Act in the following circumstances. First, any domestic issuer with at least $3 million in total assets and an outstanding class of equity securities held of record by 500 persons must register the securities pursuant to Section 12(g) of the Exchange Act and Rule 12g-1 thereunder.[264] This requirement is not applicable to debt securities, such as commercial paper or medium- or long-term notes, that are not convertible into equity securities. Second, both debt and equity securities must be registered pursuant to Section 12(b) of the Exchange Act if they are listed on a United States exchange.

A foreign bank's United States subsidiary with securities registered under Section 12 of the Exchange Act becomes subject to the continuous reporting requirements of Section 13 of that Act. The subsidiary may satisfy these reporting requirements by filing the Exchange Act reports for domestic issuers, which include an annual report on Form 10-K, quarterly reports on Form 10-Q, and periodic

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(available Aug. 13, 1979, on LEXIS, Fedsec library, Noact file); INAC Corp., SEC No-Action Letter (available Oct. 3, 1977, on LEXIS, Fedsec library, Noact file); Renault Acceptance B.V., SEC No-Action Letter (available May 26, 1977, on LEXIS, Fedsec library, Noact file). For similar positions taken by the SEC staff in other contexts, see *supra* notes 39 and 70.

262. *See infra* text accompanying notes 351-64.

263. *See supra* text accompanying notes 72-132.

264. *See supra* text accompanying notes 139-46. A domestic subsidiary of a foreign bank corporation may not rely on the exemptions for foreign private issuers set forth in Rule 12g3-2 of the Exchange Act. For a discussion of Rule 12g-3-2, see *supra* text accompanying notes 147-53.

reports on Form 8-K.[265] A foreign bank's subsidiary that has registered securities under the Securities Act also becomes subject to the continuous reporting requirements of the Exchange Act by virtue of Section 15(d) of the Exchange Act even if it is not required to register its securities pursuant to Section 12. Pursuant to Section 15(d), the subsidiary must file the same reports for domestic issuers required by Section 13 of the Exchange Act.

c. *The Investment Company Act*

A nonbanking subsidiary of a foreign bank, while not itself a foreign bank, may, nevertheless, confront the issue of whether it is an investment company under Section 3(a)(1) or 3(a)(3) of the Investment Company Act.[266] As discussed below, a United States subsidiary of a foreign bank, which might otherwise be deemed to be an investment company, may be entitled to engage in a private offering without registration by complying with Section 3(c)(1) of the Investment Company Act. In addition, a United States subsidiary may be able to effect a public offering in reliance on Section 3(c)(5) and on certain other exceptions provided by Section 3(c).[267] Lastly, exemptions under Section 6(c) of the Investment Company Act have been obtained for United States finance subsidiaries of foreign banks.

i. *Section 3(c)(1)*

Section 3(c)(1) of the Investment Company Act excepts privately held companies from the Section 3(a) definitions of "investment company."[268] Under Section 3(c)(1) an issuer that would otherwise

265. 17 C.F.R. §§ 13a-1, -11, -13 (1985). Although a discussion of reports for domestic issuers is beyond the scope of this article, it should be noted that Form 10-K requires information somewhat more extensive than that required of foreign private issuers on Form 20-F. *See supra* text accompanying notes 389-97. For example, Form 10-K contains more detailed requirements concerning business and property disclosures, transactions with management and principal shareholders, and management compensation. In addition, Form 10-Q and Form 8-K, unlike the interim reports required to be filed by foreign private issuers on Form 6-K, require disclosure of unaudited quarterly financial information and of certain material events that a foreign issuer might not be required to disclose.

266. *See supra* text accompanying notes 173-203.

267. Although the primary focus of the discussion of these exceptions is on United States finance subsidiaries of foreign banks, Section 3(c) provides a number of additional exceptions which may be relevant to a United States operating subsidiary of a foreign bank. *See supra* note 230.

268. Section 3(c)(1) of the Investment Company Act excepts from the Section 3(a) definitions of "investment company"

> Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not

be deemed to be an investment company may avoid registration under the Investment Company Act if the issuer (i) does not have more than 100 beneficial owners of its securities (other than short-term paper) and (ii) does not make, or presently (that is, currently) propose to make, a public offering of its securities.[269]

In addition, such an issuer may engage in a private placement of short-term paper to more than 100 persons (since the holders of short-term paper are not counted for this purpose) without foregoing entitlement to the Section 3(c)(1) exception.[270] Once an issuer engages in a public offering, however, the Section 3(c)(1) exemption is no longer available to it, notwithstanding the number of beneficial owners of its securities. The test in Section 3(c)(1) is thus a two-pronged one—there must be fewer than 100 beneficial owners *and* the issuer's securities must not be publicly offered.

It is possible for an issuer to rely on the Section 3(c)(1) exemption while the issuer is in the process of applying for a general exemption pursuant to Section 6(c).[271] Thus an issuer that has applied for but not yet received a Section 6(c) exemption may engage in a private placement of its securities pursuant to the restrictions of Section 3(c)(1). Subparagraph 3(c)(1)(A) states that, for purposes of computing the number of beneficial owners, any company[272] holding se-

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presently propose to make a public offering of its securities. For purposes of this paragraph:

(A) Beneficial ownership by a company shall be deemed to be beneficial ownership by one person, except that, if the company owns 10 per centum or more of the outstanding voting securities of the issuer, the beneficial ownership shall be deemed to be that of the holders of such company's outstanding securities (other than short-term paper) unless, as of the date of the most recent acquisition by such company of securities of that issuer, the value of all securities owned by such company of all issuers which are or would, but for the exception set forth in this subparagraph, be excluded from the definition of investment company solely by this paragraph, does not exceed 10 per centum of the value of the company's total assets. Such issuer nonetheless is deemed to be an investment company for purposes of Section 12(d)(1).

15 U.S.C. § 80a-3(c)(1) (1982).

269. For a discussion of the SEC's position as to what is not a public offering under the Investment Company Act, see *supra* text accompanying notes 221-29.

270. Section 2(a)(38) of the Investment Company Act defines "short-term" to include "any note, draft, bill of exchange, or banker's acceptance payable on demand or having a maturity at the time of issuance of not exceeding nine months. . . ." 15 U.S.C. § 80a-2(a)(38) (1982).

271. *See supra* notes 239-48 and accompanying text. *See also* Investment Company Act Release No. 14,814 (Nov. 26, 1985), 50 Fed. Reg. 49,650 (Dec. 3, 1985).

272. The term "company" is defined as "a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in a case under Title 11 of the United States Code or similar official or any liquidating agent for any of the foregoing in his capacity as such." *Id.* § 80a-2(a)(8).

curities of the issuer shall be considered to be one beneficial owner unless such company holds 10 percent or more of the issuer's outstanding voting securities. If the issuer's parent owns 10 percent or more of the issuer's voting securities, then each beneficial owner of the parent will be deemed to be a beneficial owner of the issuer, unless the value of all securities owned by the parent of all issuers which would be investment companies, but for the exception provided by Section 3(c)(1), does not exceed ten percent of the value of the parent's total assets.

An issuer which would be an investment company but for the exception provided in Section 3(c)(1) is deemed to be an investment company for purposes of Section 12(d)(1) of the Investment Company Act, which imposes limitations on, among other things, the acquisition of securities of investment companies by registered investment companies.[273] Subparagraph 12(d)(1)(A) limits (i) the value of the securities of an investment company (whether or not registered) permitted to be acquired by a registered investment company to no more than three percent of the outstanding voting stock of the acquired investment company and to no more than five percent of the value of the registered investment company's total assets and (ii) the value of the securities that may be acquired by a registered investment company of all investment companies to no more than ten percent of the value of the registered investment company's total assets. Thus, an issuer relying upon the Section 3(c)(1) exception[274] should be aware that the acquisition of its commercial paper by a registered investment company is subject to the limitations contained in Section 12(d)(1).[275]

ii. *Section 3(c)(5)*

Although United States finance subsidiaries of foreign banks may be set up solely to issue securities in the United States in order to

273. 15 U.S.C. § 80a-12(d)(1) (1982).

274. An issuer relying upon any other exception in Section 3(c) from the definition of investment company would not be deemed an investment company for purposes of Section 12(d)(1). However, an issuer exempted from the provisions of the Investment Company Act pursuant to a Section 6(c) exemptive order by the SEC nevertheless remains an investment company. Accordingly, any registered investment company acquiring any security of the issuer remains subject to the Section 12(d)(1) restrictions.

275. Although the prohibition contained in subparagraph 12(d)(1)(A) is, by its terms, aimed at the entity purchasing or acquiring the securities rather than at the entity issuing the security, subparagraph 12(d)(1)(H) gives the SEC the power to join the entity issuing the security as a party in an action brought to enforce the provisions of Section 12(d)(1). *See* 15 U.S.C. § 80a-12(d)(1)(H) (1982).

advance the proceeds of the issuance back to their foreign bank parents, this need not necessarily be the case. To the extent a United States finance or other operating subsidiary of a foreign bank is primarily engaged in one or more of the businesses in Section 3(c)(5) described below, it could rely on this exception from the definition of investment company. An issuer is excepted from the definition of "investment company" under Section 3(c)(5) of the Investment Company Act[276] if it does not issue redeemable securities,[277] face-amount certificates of the installment type[278] or periodic payment plan certificates,[279] and is "primarily engaged"[280] in one or more of

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276. *Id.* § 80a-3(c)(5). That Section provides that:

> Any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses:
> (A) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services;
> (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and
> (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

277. A "redeemable security" is defined in paragraph 2(a)(32) of the Investment Company Act to mean "any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets or the cash equivalent thereof." *Id.* § 80a-2(a)(32).

278. A "face amount certificate" of the installment type is defined in paragraph 2(a)(15) of the Investment Company Act to include a "security which represents an obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates more than twenty-four months after the date of issuance, in consideration of the payment of periodic installments of a stated or determinable amount . . . ." *Id.* § 80a-2(a)(15).

279. A "periodic payment plan certificate" is defined in paragraph 2(a)(27) of the Investment Company Act to include:

> (A) any certificate, investment contract, or other security providing for a series of periodic payments by the holder, and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payments, and (B) any security the issuer of which is also issuing securities of the character described in clause (A) . . . and the holder of which has substantially the same rights and privileges as those which holders of securities of the character described in clause (A) have upon completing the periodic payments for which such securities provide.

Id. § 80a-2(a)(27).

280. The term "primarily engaged" is not defined in the Investment Company Act or in rules or regulations adopted by the SEC pursuant to the Investment Company Act, nor has the meaning of the term "primarily engaged" as used in Section 3(c)(5) been interpreted by a court. There appear to be no directly relevant judicial decisions interpreting the term under other provisions of the Investment Company Act or under other federal securities laws.

Based on the ordinary, everyday meaning of "primarily engaged," on other rules of statutory construction, and on judicial decisions interpreting the meaning of "primarily engaged" or similar terms under other federal statutes, substantial arguments may be made that an issuer

the activities enumerated in Section 3(c)(5) and discussed below. If a company engages in only one of the activities described in Section 3(c)(5), this activity must be the company's "primary" business to enable it to qualify for the Section 3(c)(5) exception. If, however, a company is engaged in more than one of the activities described in Section 3(c)(5), these activities may together comprise the "primary" business of the company so as to enable it to qualify for the Section 3(c)(5) exception.

Section 3(c)(5)(A) of the Investment Company Act excepts from the Section 3(a) definition of "investment company" any person who is primarily engaged in "[p]urchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services. . . ."[281] In general, the kinds of obligations which come within the subparagraph 3(c)(5)(A) exception are those arising out of the kinds of loans which come within the 3(c)(5)(B) exception.[282]

Subparagraph 3(c)(5)(B) of the Investment Company Act, in pertinent part, excepts from the Section 3(a) definition of "investment company" any person who is primarily engaged in "making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services. . . ."[283] While the language of subparagraph 3(c)(5)(B) is broad, the SEC

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will be deemed "primarily engaged" in Section 3(c)(5) activities if at least 50% of the issuer's assets are invested in, and at least 50% of its income is derived from, the activities specified in that paragraph. *See, e.g.*, Deltide Fishing & Rental Tools, Inc. v. United States, 279 F. Supp. 661, 670 (E.D. La. 1968) (" 'primarily' means a majority, a numerical plurality"). *Cf.* Malat v. Riddell, 383 U.S. 569, 572 (1966) (the term "primarily" for the purpose of § 1221 of the Internal Revenue Code, means "of first importance" or "principally"); Board of Governors of the Federal Reserve System v. Agnew, 329 U.S. 441, 445 (1947) (firm which derived substantial portion of its gross income from all sources primarily engaged in underwriting within the provisions of § 32 of the Glass-Stengall Act). In several no-action letters, however, the SEC staff has interpreted paragraph 3(c)(5) as requiring that at least 65% of an issuer's assets be invested in, and at least 50% of its income be derived from, the activities specified in that paragraph, while other letters refer to 55% as the applicable minimum (*see infra* note 291). *See* S.S. Programs, Ltd., SEC No-Action Letter (available Oct. 17, 1974, on LEXIS, Fedsec library, Noact file); Merrill Lynch, Pierce, Fenner & Smith Inc., SEC No-Action Letter, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,089, at 77,750 (available Nov. 4, 1981). *Cf.* Banque Francaise du Commerce Exterieur, SEC No-Action Letter (available June 26, 1975, on LEXIS, Fedsec library, Noact file).

281. 15 U.S.C. § 80a-3(c)(5)(A) (1982).

282. *See* World Evangelical Dev. Ltd., SEC No-Action Letter, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,057, at 81,697 (available Apr. 5, 1979); Banque Francaise du Commerce Exterieur, SEC No-Action Letter (available June 26, 1975, on LEXIS, Fedsec library, Noact file).

283. 15 U.S.C. § 80a-3(c)(5)(B) (1982).

staff has interpreted this provision to include two requirements, neither of which is apparent from the face of the provision and both of which must be taken into account in the application of the subparagraph.

The first requirement imposed by the staff is that the lender limit its equity investment in its borrowers to no more than thirty-five percent of the lender's total assets.[284] The second requirement imposed by the SEC staff is that the loan be extended for a "sales financing" purpose.[285]

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284. *See* Lakeshore Commercial Finance Corp., SEC No-Action Letter (available Nov. 24, 1977, on LEXIS, Fedsec library, Noact file); Rio Investment Corp., SEC No-Action Letter (available Dec. 11, 1976, on LEXIS, Fedsec library, Noact file); Merchants Finance Company, Inc., SEC No-Action Letter (available Nov. 15, 1975, on LEXIS, Fedsec library, Noact file).

285. *See* Australian Indus. Dev. Corp., SEC No-action letter, [1981 Transfer Binder] FED. SEC. L. REP. (C.C.H.) ¶ 76,745 at 77,063 (available Aug. 11, 1980); World Evangelical Dev. Ltd., *supra* note 282; MESBIC, Inc., SEC No-Action Letter (available June 21, 1979, on LEXIS, Fedsec library, Noact file); Rio Inv. Corp., SEC No-Action Letter (available Dec. 11, 1976, on LEXIS, Fedsec library Noact file).

One method of determining whether a given loan has been extended for a "sales financing" purpose is to examine the borrower's use of the loan proceeds. For example, a loan specifically extended to finance the manufacture, sale or purchase of specified merchandise, insurance or services would be deemed to have been extended for a sales financing purpose. *See* Cooperative Ass'n of Tractor Dealers, Inc., SEC No-Action Letter (available June 22, 1981, on LEXIS, Fedsec library, Noact file) (applicant primarily engaged in extending loans to finance the borrowers' wholesale and retail businesses in earth-moving, construction and material handling machinery and equipment and diesel and natural gas engines); Crescent Capital Corp., SEC No-Action Letter (available Oct. 3, 1980, on LEXIS, Fedsec library, Noact file) (applicants primarily engaged in extending loans to equip, expand and maintain grocery stores); Rio Inv. Corp., SEC No-Action Letter (available Dec. 11, 1976, on LEXIS, Fedsec library, Noact file). In transactions as to which the SEC staff has issued no-action letters, loans frequently were secured by the merchandise, equipment and machinery financed.

Loans to finance a variety of other activities also have been held to have been extended for a "sales financing" purpose. For example, loans to finance capital formation projects which involve the purchase of a combination of goods and services have been held by the SEC staff to qualify. *See* AB Svensk Exportkredit, SEC No-Action Letter (available Apr. 26, 1980, on LEXIS, Fedsec library, Noact file) (applicant engaged in financing the construction of electric generating systems and subways); Development Finance Corp., *supra* note 236 (applicants primarily engaged in extending loans to finance the purchase of plants, equipment and machinery); Swedish Inv. Bank, SEC No-Action Letter (available Apr. 25, 1975, on LEXIS, Fedsec library, Noact file) (applicant primarily engaged in extending loans to finance capital investment projects and export transactions); Cable Funding Corp., SEC No-Action Letter (available July 2, 1972, on LEXIS, Fedsec library, Noact file) (applicant primarily engaged in extending loans to finance the construction of cable television systems).

The "sales financing" purpose of a loan, may, in addition, be established from the nature of the borrower's industry. Thus, a loan extended to finance the operations of a borrower who is exclusively engaged in manufacturing, wholesale, retail or purchasing activities might, under certain circumstances, be considered to have been extended for a "sales financing" purpose. *See* AB Svensk Exportkredit, SEC No-Action Letter (available Apr. 26, 1980, on LEXIS, Fedsec library, Noact file) (applicant primarily engaged in financing export sales of merchan-

Subparagraph 3(c)(5)(C) of the Investment Company Act, in pertinent part, excepts from the subsection 3(a) definition of "investment company" any issuer who is primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate."[286] The no-action letters concerning Section 3(c)(5)(C) generally fall into several categories which will be discussed separately below.

Whole Mortgage Loans. The purchase or other acquisition of whole mortgage loans will, under the circumstances described below, qualify as a subparagraph (C) activity. In accordance with requirements imposed by the SEC staff in no-action positions, the principal amount of a whole mortgage loan must be fully secured by real estate, that is, the loan must be collateralized by real estate having a value at the time of the extension of the loan at least equal to the face-amount of the obligation being secured, whether or not assets other than real estate provide additional security for the loan.[287]

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dise of Swedish manufacturers and sellers); National Rural Utilities Coop. Fin. Corp., SEC No-Action Letter, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,707, at 81,490 (available Dec. 23, 1977, on LEXIS, Fedsec library, Noact file) (applicant primarily engaged in financing the operations of borrowers exclusively engaged in generating and selling electric energy). In at least one case, the use by a borrower of close to one-half of the proceeds of a loan to finance the "soft costs" of its plant and equipment investment (i.e., for general corporate or working capital purposes) did not change the "sales-financing" nature of the loan. *See* Swedish Inv. Bank, SEC No-Action Letter (available Apr. 25, 1975, on LEXIS, Fedsec library, Noact file).

286. 15 U.S.C. § 80a-3(c)(5)(C) (1982).

287. Neither the no-action letters nor the regulations provide guidance regarding the standard to be used in determining whether real estate collateralizing a loan has a "value" at least equal to the face-amount of the loan. In the absence of any guidance, the better position is that an objective, reasonable valuation standard may properly be used. See Prescott Ball & Turben, SEC No-Action Letter (available Feb. 19, 1982, on LEXIS, Fedsec library, Noact file), in which the SEC staff stated that an issuer that is primarily engaged in the business of purchasing or otherwise acquiring notes that are fully secured solely by real estate would be excluded by subparagraph (C). The SEC staff added, however, that it was not yet prepared to take the position that an issuer primarily engaged in the business of purchasing or otherwise acquiring notes "primarily" (as opposed to "fully") secured by real estate would be so excepted. *See also* Merrill Lynch, Pierce, Fenner & Smith Inc., SEC No-Action Letter, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,089, at 77,750 (available Nov. 4, 1981).

Working interests in oil and gas properties may secure a subparagraph (C) loan in situations in which such interests constitute real property under the law of the state in which they are located. *See* Apache Petroleum Co., SEC No-Action Letter, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,212, at 77,943 (available Apr. 30, 1982). Moreover, the mortgage or other lien securing a subparagraph (C) loan need not be superior to all other liens on the real estate and applicants primarily engaged in extending loans secured by subordinate or secondary liens on real property have qualified for the subparagraph 3(c)(5)(C) exception. *See* Prudential Mortgage Bankers & Inv. Corp., SEC No-Action Letter (available Dec. 4, 1977, on LEXIS, Fedsec library, Noact file) (applicant engaged in extending second trust deed loans to homeowners); ALO Corp., SEC No-Action Letter (available Feb. 17, 1977, on LEXIS, Fedsec

Although a majority of the subparagraph (C) applicants requesting no-action letters have indicated that the proceeds of their loans would be used to finance the construction or improvement of real estate,[288] several applicants that received no-action letters did not indicate the borrower's use of the proceeds.[289]

Fractional Interests or Participations. As noted above, the purchase or other acquisition of fractional interests or participations in mortgage loans, in the SEC staff's view, is subject to a different analysis under subparagraph (C) than the analysis applicable to whole mortgage loans. Based on the SEC staff's responses to no-action requests, it appears that an issuer engaged in purchasing or otherwise acquiring fractional interests or participations in mortgage loans may rely on the subparagraph (C) exception only if the following four requirements are met: (i) the fractional interests or participations are created by the fractionalization of a whole mortgage loan or loans which has or have been purchased or otherwise acquired by the issuer; (ii) the issuer retains at least a ten percent continuing ownership interest in each whole mortgage loan which it has fractionalized; (iii) the issuer is the formal, record owner of the mortgage or mortgages securing the loan or loans; and (iv) throughout the life of the participation, the issuer has complete supervisory responsibility with respect to servicing the mortgage loan or loans and has sole discretion as to the enforcement of collections and the institution and prosecution of foreclosure or similar legal proceedings.[290]

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library, Noact file) (applicant primarily engaged in acquiring and selling first and subordinate real estate mortgages).

288. *See, e.g.*, Certco Capital Corp., SEC No-Action Letter (available Feb. 14, 1977, on LEXIS, Fedsec library, Noact file) (applicant engaged in financing the construction and improvement of grocery stores); Taylor Woodrow of California, Inc., SEC No-Action Letter, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,329, at 83,001 (available Apr. 2, 1973) (applicant engaged in financing urban renewal projects); Troutman, Sanders, Lockerman & Ashmore, SEC No-Action Letter (available Jan. 10, 1972, on LEXIS, Fedsec library, Noact file) (applicant proposing to finance the construction of churches); American Commonwealth Co., SEC No-Action Letter, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,352, at 80,813 (available May 14, 1971) (applicant engaged in financing the construction and improvement of utility properties).

289. *See, e.g.*, Prudential Mortgage Bankers & Inv. Corp., SEC No-Action Letter (available Dec. 4, 1977, on LEXIS, Fedsec library, Noact file). The subparagraph (C) exception differs from the subparagraph (B) exception in that it is based on the nature of the collateral securing an entity's loan rather than on the purpose of the loan itself. In this connection, a loan which fails to qualify for the subparagraph (C) exception by reason of the fact that it is not adequately secured by real estate may nevertheless qualify as a subparagraph (B) activity.

290. *See* First Deed Corp., SEC No-Action Letter (available Mar. 29, 1979, on LEXIS, Fedsec library, Noact file); MGIC Mortgage Corp., SEC No-Action Letter (available Aug. 1, 1974, on LEXIS, Fedsec library, Noact file).

Government Agency Mortgage Certificates. Recently a number of no-action letters have been granted by the SEC staff with respect to entities issuing bonds which are collateralized by mortgage certificates issued by government agencies such as the Government National Mortgage Association or the Federal Home Loan Mortgage Association.[291] The issuers that received the no-action positions represented that at least fifty-five percent of their assets would consist of the specified government agency certificates. Under those no-action letters, Section 3(c)(5)(C) is available with respect to entire (but not partial) issues of mortgage certificates used for collateralizing purposes, whether those certificates are backed by whole mortgages, participations in whole mortgages, or a combination of both.

iii. *Other Section 3(c) Exceptions*

Section 3(c) of the Investment Company Act contains other exclusions from the definition of "investment company" available to certain types of issuers. Exclusions are available for underwriters and brokers (Section 3(c)(2));[292] issuers in the business of making small loans (Section 3(c)(4));[293] and issuers primarily engaged, directly or through majority-owned subsidiaries, in one or a combination of the businesses described in Sections 3(c)(3), (4) and (5), or primarily engaged, directly or through majority-owned subsidiaries, in: (i) one or more of the businesses described in Sections 3(c)(3), (4) and (5) (from which not less than twenty-five percent of its gross income is derived) and (ii) an additional business or businesses other than "in-

291. *See, e.g.*, Security Mortgage Acceptance Corporation, SEC No-Action Letter (available January 6, 1986, on LEXIS, Fedsec library, Noact file) and Federal Home Loan Mortgage Corporation, SEC No-Action Letter (available June 14, 1985, on LEXIS, Fedsec library, Noact file).

292. Section 3(c)(2) provides an exception for any person primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, and acting as broker, or any one or more of such activities, whose gross income normally is derived principally from such business and related activities. *See* 15 U.S.C. § 80a-3(c)(2) (1982).

293. Section 3(c)(4) provides an exception for "any person substantially all of whose business is confined to making small loans, industrial banking, or similar businesses." *Id.* § 80a-3(c)(4). This exception applies only to consumer financing. An entity engaging in the business of making working capital loans to corporations and rendering management advice to them, and accepting the promissory notes on which it would receive interest, would not come within the exception. Commonwealth Fund, SEC No-Action Letter, [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,171, at 80,535 (available June 15, 1971). *See also* Robert D. Brody, SEC No-Action Letter, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,443, at 82,866 (available Nov. 22, 1979) ("small lender" exception confined to persons engaged in financing personal loans).

vesting, reinvesting, owning, holding or trading in securities" (Section 3(c)(6)).[294]

iv. *Section 6(c) Exemption*

As discussed above,[295] Section 6(c) of the Investment Company Act permits the SEC to exempt issuers from the provisions of the Investment Company Act if certain conditions are met. In Section 6(c) applications by United States subsidiaries of foreign banks, the SEC generally has required representations by the subsidiaries similar to those obtained from foreign banks,[296] along with the additional representation that the securities which the subsidiary proposes to offer will be guaranteed by the parent foreign bank.[297] The parent also must generally be a party to such applications since its guarantee of the subsidiary's securities may itself be the issuance of a separate security in the United States.[298]

Effective December 20, 1984, the SEC adopted Rule 3a-5 under the Investment Company Act,[299] which for the first time provides an

294. 15 U.S.C. § 80a-3(c)(6) (1982). The exclusions contained in Section 3(c), other than Sections 3(c)(1), (2), (3), (4), (5) and (6), seem to have no applicability to foreign banks, their subsidiaries or their United States branches and agencies.

295. *See supra* notes 239-48 and accompanying text.

296. *See supra* notes 243-48 and accompanying text.

297. *See, e.g., In re* Skandinaviska Enskilda Banken and Skandinaviska Enskilda Banken Funding Inc., SEC Investment Co. Act Release No. 13,601, 29 S.E.C. Docket 41 (Oct. 27, 1983) (order), SEC Investment Co. Act Release No. 13,544, 48 Fed. Reg. 45,486 (Sept. 28, 1983) (notice of filing); *In re* Bergen Bank Corp., SEC Investment Co. Act Release No. 13,994, 30 S.E.C. Docket 838 (June 5, 1984) (order), SEC Investment Co. Act Release No. 13,941, 49 Fed. Reg. 20,961 (May 10, 1984) (notice of filing); *In re* Scandinavian Bank Corp., SEC Investment Co. Act Release No. 13,831, 30 S.E.C. Docket 105 (Mar. 20, 1984) (order), SEC Investment Co. Act Release No. 13,783, 49 Fed. Reg. 7,481 (Feb. 22, 1984) (notice of filing).

298. For a discussion of whether a guarantee is a security, see *supra* note 173.

299. *See* SEC Investment Co. Act Release No. 14,275 (Dec. 14, 1984), 49 Fed. Reg. 49,441 (1984), *reprinted in* [Current Binder] FED. SEC. L. REP. (CCH) ¶ 83,719, at 87,198; 17 C.F.R. § 270.3a-5 (1985). Rule 3a-5 consists of amendments to, and a renumbering of, Rule 6c-1 (17 C.F.R. § 270.6c-1 (1985)), which contained the comparable SEC exemption for finance subsidiaries of United States parents and which had been in effect since 1968.

This rule provides to certain finance subsidiaries an exception from the definition of investment company under Section 3(a) of the Investment Company Act and an exception for the securities of such finance subsidiaries from the definition of investment securities under Section 3(a)(3) of the Investment Company Act if the finance subsidiary meets certain requirements regarding its issuances of securities and its investments. These requirements are that the parent company must unconditionally guarantee any debt securities or non-voting preferred stock of the finance subsidiary, and must provide in such guarantee that in the event of a default, the security holder may institute legal proceedings to enforce the guarantee directly against the parent without first proceeding against the finance subsidiary; the finance subsidiary may issue convertible or exchangable securities only if the securities are convertible or exchangable

exclusion from the definition of investment company for certain finance subsidiaries of foreign parents organized primarily to finance the business operations of their parents. Rule 3a-5, while expanding the categories of exempt finance subsidiaries, does not by its terms include finance subsidiaries of foreign banks since it applies only to finance subsidiaries whose parents either are not investment companies under Section 3(a) or are excepted under Section 3(b) or the rules and regulations under Section 3(a).[300] Because the current SEC position is that foreign banks are investment companies,[301] it appears that foreign banks' finance subsidiaries will have to continue to rely on individual 6(c) exemptions notwithstanding the adoption of Rule 3a-5.

2. *Federal Banking Law Reserve Considerations*

If a subsidiary of a foreign bank issues debt securities in the United States and the proceeds from the securities are loaned to or otherwise provided to a United States branch or agency of its parent foreign bank, it is possible that the branch or agency of the foreign bank could pursuant to the Federal Reserve Board's Regulation D be required to maintain reserves against such advances.[302]

As discussed in more detail below, the Federal Reserve Board's Regulation D imposes reserve requirements on, among other things, the deposits of United States depository institutions, including

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for securities issued by the parent company or for debt securities or non-voting preferred stock issued by the finance subsidiary and unconditionally guaranteed by the parent; the finance subsidiary must invest in or loan to its parent (or to a company controlled by the parent) 85% of any funds raised through an offering of debt securities or non-voting preferred stock or other borrowings soon after receipt of such funds; and the finance subsidiary may only invest in government securities, securities of its parent or a company controlled by its parent, or debt securities exempt pursuant to Section 3(a)(3) of the Securities Act.

300. The SEC position is that the Rule 3a-5 exception is not available to the finance subsidiary of a parent excepted from the definition of investment company under Section 3(c) because such parent could be engaged or could intend to engage primarily in investment company activities.

301. *See supra* note 175.

302. 12 C.F.R. Part 204 (1985). Under Regulation D, depository institutions are required to maintain reserves equal to a specified percentage of their reservable liabilities. Reserve requirements are one of the tools utilized by the Federal Reserve System to implement monetary control policy. *See* 12 C.F.R. § 204.1(b) (1985). Reserves generally take the form of an account balance maintained with a Federal Reserve Bank. *Id.* § 204.3(b). Thus, a depository institution is generally required to maintain an account balance with a Federal Reserve Bank equal to a specified percentage of such institution's reservable liabilities. Reserve requirements may, in addition to the maintenance of an account balance with a Federal Reserve Bank, be held in the form of vault cash and, in certain circumstances, in the form of an account maintained with a bank which is a member of the Federal Reserve System. *Id.*

branches and agencies of foreign banks (who together with certain affiliated companies) have total worldwide consolidated bank assets in excess of $1 billion and branches of foreign banks that are eligible to apply for federal deposit insurance.[303] Although a finance or other non-banking subsidiary of a foreign bank would not be viewed as a depository institution under Regulation D,[304] its debt securities issued in the United States would be viewed as "deposits" of a United States branch or agency of the foreign bank if the debt securities had a maturity of less than four years and the proceeds from the securities were loaned or otherwise provided to the branch or agency.

Section 204.2(a)(1)(v) of Regulation D provides that any liability of an "affiliate" of a depository institution (including a United States branch or agency of a foreign bank) with a maturity of less than four years is viewed as a "deposit" "to the extent that the proceeds are used to supply or to maintain the availability of funds (other than capital) to the depository institution."[305] A finance or other non-banking subsidiary of a foreign bank clearly would be viewed as an affiliate of a United States branch or agency of the foreign bank under Regulation D.[306] Thus, to the extent that the debt securities of a finance subsidiary of a foreign bank have a maturity of less than four years and the proceeds thereof are utilized to "fund" the United States branch or agency of the foreign bank, the debt securities would be viewed as deposits of the branch or agency under Regulation D and would be subject to Regulation D reserve requirements.[307]

C. *Obligations Issued by a United States Branch or Agency*

A foreign bank with a branch or agency in the United States may raise capital through the issuance of debt instruments by the branch or agency. As discussed below, the principal types of obligations that a branch or agency may issue are certificates of deposit, bankers' acceptances, commercial paper, notes and letters of credit.

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303. Pursuant to Section 5 of the Federal Deposit Insurance Act all United States branches of foreign banks would be eligible to apply to the FDIC for federal deposit insurance. 12 U.S.C. § 1815 (1982).

304. *See* 12 C.F.R. § 204.1(c)(1), (2) (1985).

305. *Id.* § 204.2(a)(1)(v).

306. *Id.* § 204.2(q).

307. It would be possible however to structure the debt securities so that no reserve requirements would be applicable to them. Regulation D currently imposes a zero reserve requirement with respect to liabilities having maturities of 18 months or more. *See* 12 C.F.R. § 204.9(a)(1) (1985).

Although not a seperate legal entity, a branch or agency of a foreign bank is, for some regulatory purposes, treated as a United States bank. First, securities issued by a United States branch or agency generally are afforded more favorable treatment under the federal securities laws than are securities issued directly by a foreign bank or by its nonbanking subsidiary. Second, a United States branch or agency (and to some extent the foreign bank itself) is subject to extensive regulation under state and federal banking laws similar to the regulation applicable to United States banks.[308]

1. *Types of Obligations Offered*
   a. *Certificates of Deposit*

A United States branch of a foreign bank, whether licensed under state or federal law, would typically be authorized to receive deposits in the United States.[309] Most United States agencies of foreign banks, whether licensed under state or federal law, are typically *not* authorized to receive deposits in the United States.[310] Nevertheless, certain states, such as New York, do permit agencies of foreign banks licensed under the laws of such state to issue large denomination obligations (*e.g.*, certificates of deposit for $100,000 or more).[311]

As of year-end 1980, United States branches and agencies of foreign banks had outstanding about $25 billion of certificates of deposit.[312] Until recently, most of these certificates of deposit were placed through dealers in money market instruments, although today it is not unusual for branches and agencies to sell their certificates of deposit directly to investors.[313]

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308. As discussed *supra* note 257, foreign banks owning at least a 10% voting interest in a United States "business enterprise" may become subject to various reporting requirements under the IISA. The term "business enterprise" includes a "branch," which is defined to mean "operations or activities conducted by a person in a different location in its own name rather than through an incorporated entity." 15 C.F.R. § 806.7(m) (1985). Accordingly, a branch or agency of a foreign bank licensed under the laws of one of the states is also considered to be a United States business enterprise covered by the provisions of the IISA.

309. Since the passage of the International Banking Act, foreign banks may operate branches and agencies in the United States under a federal license. *See generally* the International Banking Act of 1978 as amended, 12 U.S.C. § 3101 *et seq.* (1982).

310. *See, e.g.*, 12 U.S.C. § 3101(1) (1982); N.Y. BANKING LAW § 202-a (McKinney 1971).

311. *See* 3 N.Y.C.R.R. Part 81. A New York agency may also accept deposits without restrictions on the denomination, provided the depositors are not citizens or residents of the United States. N.Y. BANKING LAW § 202-a (McKinney 1971).

312. FEDERAL RESERVE BANK OF RICHMOND, INSTRUMENTS OF THE MONEY MARKET (5th ed. 1981).

313. *Id.* A number of United States banks (e.g., Mellon Bank, Security Pacific Bank, Continental Bank and Trust Company of Chicago) have made firm commitment underwritten offer-

b. *Bankers' Acceptances*

A bankers' acceptance is a signed promise by a bank drawee of a draft that the draft will be honored at its maturity.[314] An acceptance represents the primary, unconditional promise of the accepting bank to pay the amount of the draft at maturity.[315] A foreign bank branch or agency may become a participant in the United States bankers' acceptance market by accepting drafts drawn on the branch or agency.

Bankers' acceptances are divided into two general categories: (i) acceptances that may be discounted by a Federal Reserve Bank[316] (Eligible Acceptances) and (ii) acceptances that are not eligible for discount by a Federal Reserve Bank (Ineligible Acceptances). The distinction is important because, as discussed below, Eligible Acceptences are not reservable obligations.[317] A third category of bankers' acceptances may be purchased by the Federal Open Market Committee of the Federal Reserve System.[318]

i. *Eligible Acceptances*

Paragraph 7 of Section 13 of the Federal Reserve Act (Paragraph 7) sets forth the requirements for an Eligible Acceptance.[319] First, Paragraph 7 provides that certain depository institutions may accept drafts which arise out of certain types of transactions "having not more than six months' sight to run, exclusive of days of grace. . . ."[320] In interpreting this provision the Federal Reserve Board has taken the position that the draft underlying an Eligible Acceptance must mature not more than six months from the draft's

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ings of certificates of deposit. One advantage of using an underwriter to publicly place certificates of deposit is that it assures that the issuing bank will be able to sell a certain amount of its certificates of deposit at a particular time. It also places the risk of distribution on the underwriter rather than on the often more limited distribution facilities of the issuing bank. Another advantage is that an underwritten offering permits an issuing bank to place its certificates of deposit in a broader market than the bank could reach alone due to the superior distribution often attainable in underwritten offerings as compared to direct offerings by an issuer.

314. *See* U.C.C. § 3-410 (1977).

315. *See id.* §§ 3-410, -413.

316. Although Federal Reserve Banks are authorized by paragraph 6 of Section 13 of the Federal Reserve Act to discount such acceptances, in practice they no longer discount acceptances.

317. *See infra* notes 322-23 and accompanying text.

318. Although the Federal Open Market Committee is authorized to purchase acceptances, in practice it has discontinued such activity. *See* 70 FED. RES. BULL. 332 (1984).

319. 12 U.S.C. § 372 (1982).

320. *Id.* § 372(a).

date of issuance.[321] Second, in order to be viewed as an Eligible Acceptance, an acceptance must fall into one of three categories of transactions: (i) bankers' acceptances arising from the importation or exportation of goods; (ii) bankers' acceptances arising from the domestic shipment of goods; and (iii) bankers' acceptances secured by documents conveying or securing title to readily marketable staples.[322] According to the rules of the Federal Reserve Board, in order to categorize an acceptance as eligible, the accepting bank must stamp a legend on the acceptance describing the character of the transaction from which the acceptance arose.[323]

Paragraph 6 of Section 13 of the Federal Reserve Act (Paragraph 6) provides that a Federal Reserve Bank may discount an acceptance of the type described above provided that it is "endorsed" by at least one member bank.[324] Based solely on Paragraph 6, it would appear that an acceptance created by a branch or agency of a foreign bank must bear the endorsement of a member bank in order for such acceptance to be viewed as eligible for discount.

However, Paragraph 14 of Section 13 of the Federal Reserve Act (Paragraph 14)[325] provides that a federal reserve bank may discount paper endorsed by a branch or agency of a foreign bank in the same manner and to the same extent it may discount the same paper endorsed by a member bank, provided the foreign bank or agency maintains reserves pursuant to Section 7 of the International Banking Act.[326] Under the International Banking Act, a branch or agency of a foreign bank must maintain reserves if the foreign bank (together with certain affiliated banks) has total worldwide assets in excess of $1 billion or the branch is eligible to apply for federal deposit insurance.[327] Based on Paragraph 14, branches and agencies of foreign banks required to maintain reserves may create Eligible Acceptances as long as such acceptances meet the criteria for eligibility set forth in Paragraph 7.[328]

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321. *See* 1922 FED. RES. BULL. 52.

322. 12 U.S.C. § 372(a) (1982). A fourth category of Eligible Acceptances consists of drafts drawn by a bank in a foreign country for the purpose of furnishing dollar exchange. *See id.* § 373.

323. 1928 FED. RES. BULL. 517.

324. 12 U.S.C. § 346 (1982).

325. *Id.* § 347d.

326. *Id.* § 3105.

327. For a discussion of the reserve requirements on deposits, see *infra* text accompanying notes 372-380.

328. Acceptances created by a branch or agency that is not required to maintain reserves would not be eligible for discount by Federal Reserve Banks.

ii. *Ineligible Acceptances*

Ineligible Acceptances are acceptances not eligible for discount by a Federal Reserve Bank and include acceptances, discussed below, which are eligible for *purchase* but not for *discount* by a Federal Reserve Bank. Whereas, as discussed above, an Eligible Acceptance must arise from only certain specified types of transactions, there are no restrictions on the types of transactions which may be financed with Ineligible Acceptances. For example, a depository institution, such as a branch or agency of a foreign bank, could finance its customer's working capital requirements by establishing a bankers' acceptance for such customer.

Although most depository institutions may create both Eligible and Ineligible Acceptances, Ineligible Acceptances have a number of disadvantages compared to Eligible Acceptances. As discussed below, a depository institution's liability in respect of an Eligible Acceptance is not subject to reserve requirements under Regulation D of the Federal Reserve Board, whereas generally an Ineligible Acceptance, unless discounted and held by the depository institution, is subject to reserve requirements.[329] Because the accepting depository institution need not maintain reserves against Eligible Acceptances, the depository institution's cost of establishing such bankers' acceptances are lower than for Ineligible Acceptances, which are subject to Regulation D reserve requirements.[330] This cost savings, in turn, can be passed on to the depository institution's customers in the form of a lower discount rate on the acceptance.

Ineligible Acceptances of federal branches and agencies are subject to the lending limits applicable to national banks.[331] In contrast, although Section 13 of the Federal Reserve Act imposes limits on the creation of Eligible Acceptances,[332] the limits are separate from

329. *See* 12 C.F.R. § 204.2(a)(1)(vii)(E) and (viii) (1985). Once a draft has been accepted by a depository institution it may be sold at a discount from the face value by the holder to any depository institution, including the institution that accepted it. It is a common practice for the accepting bank to purchase ("discount") its own acceptance and either hold them for its own account or rediscount them to other depository institutions. The amount of the discount from the face value of the acceptance reflects the time value of money and is in the nature of interest.

330. *Id.* § 204.2(a)(1)(viii).

331. 12 U.S.C. § 84 (1982). For a state branch or agency, the lending limits of applicable state law must be examined. New York, for example, provides an exception to the lending limits for acceptances that are secured or acceptances that are Eligible Acceptances under federal law and that are issued by others. N.Y. BANKING LAW § 103 (McKinney Supp. 1985).

332. *Id.* § 372. Section 13 of the Federal Reserve Act limits the amount of eligible bankers' acceptances that may be created by, among others, a Federal or state branch or agency of a foreign bank whose parent bank has, or is controlled by a foreign company or companies that

the lending limits applicable to national banks[333] and to federal branches and agencies of foreign banks.[334] As a result, a federal branch or agency may make a loan to its customer up to the applicable lending limit and subsequently, provided the resulting acceptances are eligible, accept drafts drawn by the customer up to the applicable limit contained in Section 13 of the Federal Reserve Act.[335]

Another disadvantage of Ineligible Acceptances is that the secondary market for such acceptances is smaller than the market for Eligible Acceptances[336] and that such acceptances trade at a deeper discount.[337] Despite their disadvantages, the issuance of Ineligible Acceptances may be attractive to a foreign branch or agency which has reached its ceiling for issuing Eligible Acceptances and has a customer drawing drafts which have not yet reached the branch or agency's per customer lending limit.[338]

iii. *Acceptances Eligible for Purchase*

Although Federal Reserve Banks are authorized to discount only those acceptances which meet the criteria set forth in Paragraph 7 discussed above, the Federal Reserve Bank of New York is permitted to *purchase* certain types of acceptances as authorized by the Federal Open Market Committee. Under the most recent guidelines published by the Federal Open Market Committee, the Federal Reserve Bank of New York is authorized to purchase prime bankers' acceptances with maturities of up to nine months at the time of acceptance that: (i) arise out of the current shipment of goods between

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have, more than $1 billion in total worldwide consolidated assets to 150 percent of the United States dollar equivalent of its paid up and unimpaired capital and surplus (capital) and, with the permission of the Federal Reserve Board, up to 200 percent of its capital. *See id.* §§ 372(b), (c), 3105(a)(2). *See also* 12 C.F.R. § 204.1(c)(2) (1985). Section 13 of the Federal Reserve Act also prohibits, among others, a Federal or state branch or agency of a foreign bank with the requisite amount of worldwide assets, from creating Eligible Acceptances for one person in an amount in excess of 10 percent of the foreign bank's capital and limits the amount of Eligible Acceptances growing out of domestic transactions to 50 percent of the aggregate amount of all bankers' acceptances authorized for that branch or agency. 12 U.S.C. § 372(d), (e) (1982).

333. *See* 12 U.S.C. § 84 (1982).

334. *See id.* § 3102(b).

335. *See id.* § 372.

336. Ryan, *Bankers' Acceptances*, in LETTERS OF CREDIT AND BANKERS' ACCEPTANCES 182 (Practising Law Institute ed. 1983).

337. *Id.*

338. Presumably, a foreign branch or agency which has reached its ceiling for issuing eligible acceptances could issue a draft which would normally qualify as an eligible acceptance and that draft would be treated as an ineligible acceptance.

countries or within the United States or (ii) arise out of the storage within the United States of goods under contract for sale or expected to move into channels of trade within a reasonable time and that are secured throughout their life by a warehouse receipt or similar document conveying title to the underlying goods, provided that the aggregate amount of bankers' acceptances held by the Federal Reserve Bank at any one time shall not exceed $100 million.[339]

In order for an acceptance to be eligible for purchase by the Federal Reserve Bank of New York, the acceptance must be viewed as "prime" by the Federal Reserve Bank of New York. A foreign bank's branch or agency seeking to have its acceptances purchased by the Federal Reserve Bank of New York must satisfy the requirement that the acceptances are prime and must satisfy certain documentation requirements.[340] If a bank's acceptances are traded in the bankers' acceptance market, the Federal Reserve Bank of New York can more easily reach a judgment regarding the marketability of the paper and whether it is considered prime by the marketplace.[341]

c. *Letters of Credit*

A branch or agency of a foreign bank, which is licensed under state or federal law, typically is authorized to issue letters of credit in the United States. Additionally, while federal branches and agen-

339. 48 Fed. Reg. 15,325 (1983).

340. The documents to be lodged by branches or agencies of foreign banks with the Federal Reserve Bank of New York are: (1) a certificate of resolution (in the form required by the Federal Reserve Bank of New York) of the board of directors of the foreign bank, (2) a certification (in the form required by the Federal Reserve Bank of New York) by the principal officer or representatives of the agency or branch of the names, titles, and specimen signatures of persons authorized to sign acceptances, (3) a certified copy of the license to do business issued by the state in which the branch or agency office is located, (4) a copy of the letter to the State Banking Department requesting and authorizing the department to furnish the Federal Reserve Bank of New York with copies of all reports of examinations of the foreign agency or branch, (5) an opinion of the United States counsel to the foreign bank as to the authority of such bank to accept bills of exchange drawn upon it, (6) a letter of transmittal from the foreign branch or agency addressed to the Federal Reserve Bank of New York, accompanying the foregoing documents and containing a written undertaking by the agency or branch that it will inform the Federal Reserve Bank, at its request, of the details of any transactions underlying the acceptances, (7) whenever the principal officer or representative is to be succeeded, a certification (in the form required by the Federal Reserve Bank of New York) by the principal officer or representative of the status and signature of his successor, and (8) such financial statements as the Federal Reserve Bank of New York may require. Helfrich, *Trading in Bankers' Acceptances: A View from the Acceptance Desk of the Federal Reserve Bank of New York*, FEDERAL RESERVE BANK OF NEW YORK, MONTHLY REVIEW 56-57 (Feb. 1976).

341. *Id.* at 56.

cies generally are not permitted to issue guarantees, a branch or agency licensed under state law may be authorized under applicable state law to issue guarantees in the United States.[342] In the context of the United States securities markets, a branch or agency may lend its credit rating to another entity by issuing a credit or a guarantee which would support payment of such entity's securities issued in the United States.

For example, an entity, such as a finance subsidiary of a foreign bank, may not have adequate credit ratings to access the United States commercial paper market but may, nevertheless, desire to enter this market. A branch or agency of the foreign bank may assist the entity in gaining access to the commercial paper market by issuing a letter of credit which would support payment of such entity's commercial paper when due. By issuing a letter of credit to support the commercial paper, the commercial paper may be rated on the basis of the credit standing of the branch or agency of the foreign bank.

d. *Commercial Paper*

A foreign bank could utilize its United States branch or agency to issue commercial paper in the United States. However, because commercial paper issued by such a branch or agency would be reservable under Regulation D of the Federal Reserve Board while commercial paper issued by the foreign bank (other than through such branch or agency) or a United States finance or other subsidiary of the foreign bank would not be reservable, branches or agencies or foreign banks rarely if ever issue commercial paper in the United States.[343]

e. *Certificate of Deposit Notes*

Recently, at least one United States branch of a foreign bank has issued debt obligations in the form of "certificate of deposit notes." Certificate of deposit notes are unsecured debt obligations ranking *pari passu* with the deposits and other unsecured debt obligations of the branch which may be treated by the issuing branch for certain banking and accounting purposes as deposits but are styled as notes and marketed consistently with procedures customarily utilized in connection with corporate bond issuances. Such procedures might in-

342. *See, e.g.*, N.Y. BANKING LAW § 96(9) (McKinney Supp. 1985), which permits the issuance of guarantees that are incidental to carrying on the business of a bank.

343. 12 C.F.R. § 204.2(a)(1)(vii) (1985) *See supra* text accompanying notes 302-307.

clude the use of an offering circular, the use of a fiscal and paying agency agreement or similar instrument to provide additional rights to investors and the obtaining of a rating for the certificate of deposit notes. The utilization of such techniques facilitates the marketing of the certificate of deposit notes to the United States corporate bond market, a market in which foreign banks and their United States branches and agencies historically have not participated.

2. *The Federal Securities Laws*

A foreign bank issuing obligations through a United States branch or agency may take advantage of any of the exemptions from the registration provisions of the various federal securities laws discussed above. In addition, however, the following exceptions from the registration requirements are available by virtue of the branch or agency's status as a United States banking entity.

a. *The Securities Act*

i. *Certificates of Deposit as Securities*

Since the registration requirements of the Securities Act apply only to instruments that are securities within the meaning of Section 2(1) of the Act, obligations of United States branches and agencies of foreign banks that are not securities need not be registered. As discussed above, it is not entirely clear, on the basis of *Weaver*[344] and *Wolf*,[345] whether certificates of deposit issued by foreign banks directly are securities for purposes of the federal securities laws. While a stronger case can be made that certificates of deposit issued by United States branches and agencies of foreign banks are not securities, this issue remains unresolved.

Although there have been no court cases that have considered whether certificates of deposit issued by United States branches or agencies of foreign banks are considered securities for the purposes of the federal securities laws, branches of foreign banks insured by the FDIC are subject to substantially the same regulatory requirements as was the federally-insured, state-chartered bank in *Weaver*. Based on the Supreme Court's analysis in *Weaver*, therefore, certificates of deposit issued by insured branches should not be considered

344. 455 U.S. 551 (1982). *See supra* text accompanying notes 27-30.

345. 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 105 S. Ct. 784 (1985). *See supra* text accompanying notes 31-37.

securities for purposes of the federal securities laws.[346] Moreover, since, as interpreted by *Wolf*, the *Weaver* decision did not turn on the existence of federal deposit insurance, it can be argued that the state and federal banking regulation imposed on domestic branches and agencies of foreign banks (whether or not insured) should provide depositors sufficient assurances against loss that the protections of the federal securities laws are unnecessary.[347]

On the other hand, it can be argued that depositors of uninsured branches and agencies of foreign banks may not have some of the protections that the courts in both *Weaver* and *Wolf* found significant. The court of appeals in *Wolf* concluded that the Supreme Court's holding in *Weaver* turned on the fact that repayment in full was virtually guaranteed. The *Wolf* court did not articulate a standard for determining whether repayment in full is virtually guaranteed. Rather the court of appeals' decision turned on the fact that "it was conceded that the Mexican government's regulation of [Banco Nacional de Mexico] provides its certificate holders the same degree of protection against insolvency as does the federal system in this country." The court also noted that no bank in Mexico had failed in 50 years.[348]

Because the *Wolf* court did not articulate a standard, it is uncertain what result might be reached for certificates of deposit for an uninsured bank in the United States since it can hardly be claimed that no national or state banks in the United States have ever failed. As a result, the system of state and federal regulation governing uninsured United States branches and agencies of foreign banks may not be sufficient to substitute for a lack of deposit insurance. Second, in *Weaver*, the Supreme Court noted that, even though the certificate of deposit involved in the case was only partially insured, the

346. While all United States branches and agencies of foreign banks are subject to federal regulation, agencies and certain branches of foreign banks are not subject to federal insurance requirements.

347. In fact, in its brief in *Wolf*, the SEC seems to assume this result, at least with respect to branches of foreign banks:

> Foreign banks that wish to sell their time deposits in this country without Securities Act registration may do so by issuing them in this country from domestic branches that are subject to federal bank regulation. In 1978, Congress extended the network of federal regulation of banking to include American branches of foreign banks by passing the International Banking Act of 1978. That Act permits branches of foreign banks to subject themselves to regulation at the federal level. 12 U.S.C. §§ 3101 *et seq.* As was the case in *Weaver*, the context of this substantial federal bank regulation should obviate the need for coverage of the federal securities laws.

SEC Brief, 11 n.24.

348. 739 F.2d 1458, 1463 (9th Cir. 1984).

FDIC has had a history of paying depositors in full, even beyond the insured amounts.[349] Depositors of uninsured branches or agencies of foreign banks, however, could not rely on the FDIC for payment.[350]

ii. *Exemption for Bank Issued or Guaranteed Securities*

Section 3(a)(2) of the Securities Act, which provides an exemption from the Act's registration requirements for securities issued or guaranteed by national banks and state-chartered banking institutions, does not by its terms apply to securities of foreign banks.[351] In a series of no-action letters issued since 1964, however, the SEC staff has administratively broadened the exemption to make it available under certain circumstances to United States branches and agencies of foreign banks.

The staff's position in these no-action letters generally is based on the premise that, although licensing of a branch or agency of a foreign bank under federal or state law is not identical to being a "national bank" or "organized under the laws of any State" within the meaning of Section 3(a)(2), the nature and extent of supervision and regulation of the branch or agency by federal and state banking authorities is equivalent to that of national banks or banks chartered in that state. As a result, availability of this administrative exemption to a United States branch or agency depends largely on the branch or agency being able to demonstrate that it is subject to the same state and federal regulation as a national bank or state-chartered bank would be in such areas as reporting and recordkeeping requirements, interest-rate regulation, maintenance of reserves, lending limits, financial condition, examination and inspection procedures, and nonbanking restrictions.[352]

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349. *See also* Brockton Savings Bank v. Peat, Marwick, Mitchell & Co., 577 F. Supp. 1281, 1285-86 (D. Mass. 1983), in which the court rejected plaintiff's argument that *Weaver* intended to exclude certificates of deposit from the coverage of the securities laws only up to the ceiling of federal deposit insurance coverage.

350. Uninsured deposits of insolvent banks frequently are paid by the FDIC in connection with an acquisition of the failed bank by another bank. Although all depositors generally are fully protected even for uninsured amounts, the FDIC in 1984 announced an experimental policy pursuant to which uninsured depositors would receive only a portion of the amount of their deposits from the FDIC. *See, e.g.*, FDIC Press Release, No. 19 (March 16, 1984), 49 Fed. Reg. 11,054 (Mar. 23, 1984) (announcing payoff of the Seminole National Bank). Recently, however, FDIC staff members have suggested the FDIC has abandoned this experimental policy. Bank Letter, Feb. 25, 1985, at 7, col. 2.

351. *See supra* text accompanying note 70.

352. Typical of the favorable responses given by the staff of the SEC regarding securities issued by United States branches or agencies of foreign banks is the letter issued to the New York Agency of Banco do Commercio e Industria de Sao Paulo S.A., a Brazilian bank, in

Since the exemption for branches and agencies is merely an administrative position created by the SEC staff in no-action letters, its status as a matter of law under Section 3(a)(2) of the Securities Act is uncertain and the only authority currently available for determining the availability and scope of the exemption is the staff's no-action and interpretive positions. As discussed below, the staff has issued numerous letters addressing the issuance of letters of credit, certificates of deposit, or notes by branches or agencies of foreign banks located in the United States.

(A) *Letters of Credit*

United States branches and agencies of foreign banks often have issued letters of credit or other guarantees in support of the debt securities of other issuers. Since a guarantee is a security separate from the underlying security being supported, both the guarantee

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connection with the New York Agency's issuance of certificates of deposit with maturities of up to five years. The response stated, in part:

> Although licensing under state law of a domestic branch of a foreign bank is not identical to being "organized under the laws of any State . . ." the staff has issued numerous no-action letters in the past relating to the issuance by such branches of certificates of deposit or similar forms of debt securities.
>
> The facts set forth in your letter indicate that the New York Agency of the Bank is licensed under the banking laws of the State of New York and therefore is subject to regulation and supervision by the banking authorities of that state. Moreover, the certificates of deposit will be issued by the Agency only with the acquiescence of the New York Superintendent of Banks following compliance with procedures set forth in requirements promulgated by the Superintendent. On the basis of these facts, this Division will not recommend any enforcement action to the Commission if the New York Agency of the Bank, in reliance upon your opinion as counsel that registration is not required, issues the certificates of deposit as described without compliance with the registration provisions of the [Securities] Act.

Banco do Commercio e Industria de Sao Paulo S.A. (New York Agency), SEC No-Action Letter, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,082, at 77,728 (available Nov. 30, 1981).

In a more recent no-action letter involving the issuance of letters of credit by a Los Angeles branch of another foreign bank, the SEC staff stated that, in taking its position, it had been particularly influenced by representations contained in a supplemental request letter (presumably submitted at the suggestion of the staff) that "the extent and nature of state and federal bank regulation of the Los Angeles branch are substantially equivalent to that applicable to California State-chartered domestic banks." Banque Indosuez (Los Angeles Branch), SEC No-Action Letter (available May 7, 1984, on LEXIS, Fedsec library, Noact file). Similarly, with respect to federally-licensed branches, the SEC staff has relied on representations that the extent of federal regulaton is substantially equivalent to that of a national bank. *See, e.g.*, National Australia Bank, Ltd. (Chicago limited federal branch), SEC No-Action Letter (available July 29, 1985, on LEXIS, Fedsec library, Noact file).

and the underlying security must qualify for separate exemptions from the registration requirements of the Securities Act.[353]

The no-action letters of the SEC staff dealing with letters of credit issued by United States branches or agencies of foreign banks set forth the circumstances under which the SEC staff will consider (i) a letter of credit or other guarantee issued by the branch or agency to be equivalent to a security "issued" by a bank within the meaning of Section 3(a)(2) of the Securities Act and (ii) securities supported by the letter of credit or other guarantee to be equivalent to securities "guaranteed" by a bank within the meaning of Section 3(a)(2). Until recently, certain no-action letters issued by the staff of the SEC's Division of Corporate Finance raised the possibility that the nature of the security being supported by a United States branch or agency's letter of credit would be a factor in the SEC staff's determination whether the Section 3(a)(2) exemption was available for either the letter of credit or the underlying security. As discussed below, however, the staff's current no-action positions disregard this factor.

Over a number of years, the SEC staff has granted no-action letters that permit a United States branch or agency to issue letters of credit without registration under the Securities Act provided the securities supported by the letters of credit are exempt from registration on their own merits, without regard to the branch's guaran-

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353. The argument has been made that a letter of credit issued by a United States branch or agency should be entitled to the exemption from registration to which the supported securities are entitled. Counsel for the Los Angeles branch of Fuji Bank, Ltd. proposed the following rationale for its view that its letters of credit in support of commercial paper should be entitled to share in the paper's Section 3(a)(3) exemption:

> Since the essential characteristics of the guarantees are derived entirely from the notes to which they are attached, in our opinion the letters of credit of the Fuji Bank should be regarded as the same class of security as the attached notes which they guarantee. Moreover, the guarantor's liability is like that of a co-maker of a note in that a guarantor waives notice of dishonor and protest, as well as all demands on the maker of a note in the event of default in the payment on that note. Similarly, the obligations of the Fuji Bank on the letters of credit will not materially differ from those of the issuers of notes; on the maturity date of the note, the Fuji Bank will be obligated to make payment if the issuer does not. There would appear to be no basis for any distinction between commercial paper notes guaranteed by a parent or affiliate and those carrying a similar guarantee in the form of a letter of credit.

Fuji Bank, Ltd. (Los Angeles Branch), SEC No-Action Letter (available Oct. 15, 1979, on LEXIS, Fedsec library, Noact file). *Accord* Mitsui Bank, Ltd. (New York Branch), SEC No-Action Letter (available Oct. 15, 1979, on LEXIS, Fedsec library, Noact file). Although the staff of the SEC issued the Fuji and Mitsui no-action letters, it based its decision on the exemption afforded by Section 3(a)(2) for bank issued or guaranteed securities rather than on the Section 3(a)(3) exemption for commercial paper. *But see supra* notes 70 and 261.

tee.[354] Types of securities that could be supported by a branch or agency's letter of credit in this manner would include, among others, industrial development bonds issued by municipalities and state agencies that are exempt from registration pursuant to separate provisions of Section 3(a)(2) of the Securities Act and commercial paper exempt pursuant to Section 3(a)(3) of the Securities Act.

With respect to transactions in which the United States branch or agency of a foreign bank issues letters of credit in support of debt securities which are not themselves exempt from registration, the SEC staff has taken several different and somewhat anomalous positions which, until recently, had the effect of conditioning the availability of the Section 3(a)(2) exemption for branches and agencies on the maturity of the securities being supported by the letters of credit. The staff has consistently granted no-action letter requests in which a branch or agency in the United States proposed to issue letters of credit in support of debt securities with maturities not exceeding two years.[355] In each of these instances, the Section 3(a)(2) exemption was made available to both the letters of credit and the underlying securities supported by the letters of credit.

In 1982, however, the SEC staff considered a no-action letter request by National Westminster Bank Limited (*NatWest*), which involved the first request by a branch or agency proposing to issue letters of credit in support of notes with maturities in excess of two

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354. *See, e.g.*, Banque Indosuez (Los Angeles Branch), SEC No-Action Letter (available May 7, 1984, on LEXIS, Fedsec library, Noact file) (letters of credit supporting tax-exempt notes and bonds); Banque Paribas (Los Angeles Agency), SEC No-Action Letter (available Nov. 18, 1983, on LEXIS, Fedsec library, Noact file) (letters of credit supporting industrial development bonds).

355. *See, e.g.*, CRA (Argyle) Finance Ltd., SEC No-Action Letter (available Sept. 17, 1984, on LEXIS, Fedsec library, Noact file); In re Industrial Bank of Japan, Ltd., SEC No-Action Letter (available Feb. 10, 1984, on LEXIS, Fedsec library, Noact file). Most of the request letters in this area have involved short-term commercial paper for which no exemption under Section 3(a)(3) was claimed.

Typical of the responses given to requests for no-action letters by United States branches and agencies of foreign bank is the letter issued to Barclays Bank, in which the staff of the SEC stated:

> Although licensing under state law of a domestic branch of a foreign bank is not identical to being "organized under the laws of any State . . .," the staff has issued numerous no-action letters in the past relating to the issuance by such branches of letters of credit or similar guarantees supporting the securities of other issuers. Generally, the underlying securities subject to the guarantees have had relatively short maturities (*i.e.*, two years or less) or have been exempt from registration on their own merits, without regard to the branch's guarantee.

Barclays Bank Int'l Ltd. (New York Branch), SEC No-Action Letter, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,080, at 77,721 (available Nov. 30, 1981).

years.[356] The staff declined to grant this request and stated that it would not take a no-action position with respect to letters of credit issued by United States branches and agencies of foreign banks where the underlying securities were not themselves entitled to an exemption (other than a transactional exemption) under the Securities Act or had maturities in excess of two years.[357]

The staff's position in *NatWest* had two unfortunate effects. First, it clearly conditioned the availability of the Section 3(a)(2) exemption on the nature of the underlying securities. Second, it established an entirely arbitrary two-year maturity limitation that bore little if any relationship to the soundness of the securities supported by the branch's or agency's letter of credit.[358]

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356. National Westminster Bank Ltd. (Chicago Branch), SEC No-Action Letter, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,081, at 77,726 (available Nov. 30, 1981) [hereinafter cited as NatWest]. Since the underlying securities were being issued in an exempt transaction, the request for a no-action position under Section 3(a)(2) involved only the letters of credit and not the supported securities. Although presumably the letters of credit also could have been offered without registration pursuant to Section 4(2) of the Securities Act, the branch or agency, as the issuer of the letters of credit, would have had to comply with the disclosure requirements of that exemption. *See supra* notes 89-99 and accompanying text.

There are no similar disclosure requirements imposed in order for securities to be exempt under Section 3(a)(2) of the Securities Act although such securities would still be subject to the general antifraud provisions established under Section 17 of the Securities Act and Section 10(b) of the Exchange Act. *See supra* notes 138 and 159-161 and accompanying text.

By their terms, the antifraud provisions of Section 12(2) of the Securities Act would not apply to securities exempt pursuant to Section 3(a)(2). *See supra* notes 135-36 and accompanying text. Since the availability of the exemption for branches and agencies is only an administrative position taken by the SEC staff with respect to registration requirements, however, it is unsettled whether securities issued or guaranteed by a branch or agency would be viewed as exempt under Section 3(a)(2) for purposes of Section 12 of the Securities Act. The SEC staff's no-action letters, nevertheless, are likely to be given considerable weight by a court in any action arising under Section 12(2).

357. *Id.*

358. The position, moreover, did not appear to serve any legitimate interest or concern under Section 3(a)(2). As discussed above, provided that a United States branch or agency of a foreign bank is subject to the same degree of supervision and regulation as a United States bank, the precise nature of the securities issued by it should be irrelevant in determining whether the securities should be entitled to an exemption from the registration requirements of the Securities Act pursuant to Section 3(a)(2).

Furthermore, the constraints imposed by the NatWest letter with respect to the issuance of letters of credit or guarantees by a United States branch or agency of a foreign bank were neither logical nor in accord with the SEC staff's views as enunciated in concurrent no-action responses given regarding the issuance of certificates of deposit and other debt securities by such branches or agencies. Even if one were to accept the premise that there is a legitimate policy served by restricting the maturity of debt securities issued by a United States branch or agency of a foreign bank, there does not appear to be any reason for the SEC staff to have established a shorter term for letters of credit or guarantees than for other debt securities issued by a branch or agency. The risk, if any, present when the branch or agency issues a letter of credit or guarantee would not appear to be materially greater than when it issues a

In 1984, the staff partially reversed *NatWest* by granting a no-action letter to Boettcher & Company, Inc. (*Boettcher*), in which the maturity of the debt securities underlying the letter of credit was five years.[359] *Boettcher* had the desirable effect of extending the availability of the Section 3(a)(2) exemption to letters of credit supporting medium-term obligations that were not otherwise exempt from registration. *Boettcher* did not, however, remove the possibility that the exemption remained conditioned on some maximum maturity for the underlying securities. It, therefore, remained unclear whether the SEC staff would extend its administrative exemption under Section 3(a)(2) to letters of credit in support of securities with maturities in excess of five years.

Recently, however, the staff has taken several no-action positions that have resolved this uncertainty. In at least three instances within the past year, the SEC staff has issued no-action letters permitting (i) letters of credit issued by a branch or agency of a foreign bank in the United States and (ii) various debt obligations supported by the letters of credit, including debt securities with no specified maturity limitations, to be offered and sold without registration under the Securities Act.[360] As a result, it appears that the availability of the exemption under Section 3(a)(2) of the Securities Act no longer depends on the nature or maturity of the securities supported by a branch or agency's letter of credit.

(B) *Certificates of Deposit and Notes*

The SEC staff has been more consistent in granting no-action positions under Section 3(a)(2) of the Securities Act to United States branches or agencies of foreign banks proposing to issue debt obligations in the United States than it has been with respect to issuances by such branches and agencies of letters of credit in support of another issuer's debt securities. Although most of these letters concerning directly issued debt obligations have involved certificates of de-

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certificate of deposit or similar debt security. Indeed, it could be argued that the risk is reduced when issuing a letter of credit or guarantee because of the contingent nature of the liability incurred by the letter of credit or guarantee.

359. Boettcher & Co., SEC No-Action Letter (available Dec. 16, 1984) [hereinafter cited as Boettcher].

360. National Australia Bank, Chicago Branch, SEC No-Action Letter (available July 29, 1985, on LEXIS, Fedsec library, Noact file); Swiss Bank Corp., SEC No-Action Letter (available October 21, 1985, on LEXIS, Fedsec library, Noact file); The Mitsubishi Bank, Ltd., New York Branch, SEC No-Action Letter (available Nov. 21, 1985, on LEXIS, Fedsec library, Noact file).

posit, on occasion the staff has received and granted no-action requests with respect to the issuance of non-deposit obligations such as notes.[361] As a result, it seems likely that the SEC staff's position with respect to directly issued debt obligations does not depend on the type of debt obligation being offered by a United States branch or agency of a foreign bank.[362]

Because the staff's no-action letters do not address all fact situations, however, and because of the past uncertainties in the staff's no-action letters involving letters of credit, certain ambiguities have continued to surround the availability of the Section 3(a)(2) exemption for certificates of deposit and other debt obligations issued by a branch or agency.

One issue regarding the availability of the Section 3(a)(2) exemption to the issuance of debt obligations by a United States branch or agency of a foreign bank is whether the maturity of the security would affect the availability of the exemption. The staff, for example, has not responded to any no-action letter requests involving certificates of deposit in excess of seven years.[363] Since there is no indi-

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361. *See, e.g.*, Bayerische Landesbank Girozentrale (New York Federal Branch), SEC No-Action Letter (available June 10, 1983, on LEXIS, Fedsec library, Noact file) (commercial paper notes with maturities up to two years).

The staff of the SEC's Division of Corporation Finance has recently indicated to the author that it is considering the possibility of issuing an interpretive release concerning the availability of the Section 3(a)(2) exemption to issuances of debt securities by the United States branches and agencies of foreign banks. While the content of such a release cannot be established at this time, it is possible that the staff might use an interpretive release to establish "safe harbor" standards with respect to the availability of the exemption that would lessen the need for United States branches and agencies of foreign banks and counsel to seek no-action letter comfort from the SEC.

362. There is no indication in these no-action letters that the SEC staff would view certificates of deposit differently from other debt instruments on the theory that the former are not securities for purposes of the Securities Act. *See supra* text accompanying notes 344-50. In fact, in one recent no-action letter in which counsel for a United States branch of a foreign bank initially requested a no-action position on the grounds that the branch's certificates of deposit were not securities, the SEC staff replied: "It is not the policy of [the Division of Corporation Finance] to provide a legal determination as to what is or is not a security in the context of no-action letter requests, and we decline to do so here." Toronto-Dominion Bank (New York Branch), SEC No-Action Letter (available Feb. 24, 1984, on LEXIS, Fedsec library, Noact file). Instead, the SEC staff granted a no-action position pursuant to the exemption provided by Section 3(a)(2) of the Securities Act.

363. The majority of no-action requests regarding certificates of deposit issued by United States branches and agencies of foreign banks have involved certificates of deposit with maturities not in excess of five years. Indus. Bank of Japan, Ltd. (New York Agency), SEC No-Action Letter (available June 26, 1981, on LEXIS, Fedsec library, Noact file) (certificates of deposit, maturities of up to five years, $200,000 minimum principal amount); Sumitomo Trust and Banking Co., Ltd. (New York Branch), SEC No-Action Letter (available Dec. 27, 1978, on LEXIS, Fedsec library, Noact file) (certificates of deposit, maturities of up to five years, $100,000 minimum principal amount); Nippon Credit Bank Ltd. (New York Branch), SEC

cation in SEC no-action responses issued by the staff that the staff imposed any maturity limitations as a condition to its granting no-action relief, it is likely that the SEC staff does not consider the maximum maturity of debt obligations offered by a United States branch or agency of a foreign bank to be a significant factor in determining whether the exemption provided by Section 3(a)(2) is available.[364]

It is, nevertheless, possible that the staff could take the position, for example, that the maturity of a non-deposit obligation, such as a note, was relevant to the availability of the Section 3(a)(2) exemption or that some maximum maturity was required for debt obligations offered in small denominations. The author understands that, at the time of this writing, there are currently pending before the staff of the SEC's Division of Corporation Finance at least four no-action letter requests seeking further clarity in this area, at least one of which involves the issuance by United States branches or agencies of foreign banks without registration under Section 3(a)(2) of debt securities with maturities in excess of seven years.

No-Action Letter (available Nov. 21, 1977, on LEXIS, Fedsec library, Noact file) (certificates of deposit, maturities of up to five years, $100,000 minimum principal amount); Taiyo Kobe Bank, Ltd. (New York Branch), SEC No-Action Letter (available Aug. 1, 1977, on LEXIS, Fedsec library, Noact file) (certificates of deposit, maturities of up to five years, $100,000 minimum principal amount in most cases). On the other hand, one request letter for which no-action relief was granted merely stated that the maturities of the certificates of deposit to be issued would be in excess of nine months. Bank Leumi Le-Israel B.M. (Pennsylvania Branch), SEC No-Action Letter (available Apr. 9, 1979, on LEXIS, Fedsec library, Noact file) (certificates of deposit, maturities longer than nine months, no stated principal amount). In addition, at least two recent no-action requests granted by the SEC staff have dealt with certificates of deposit with possible maturities of up to seven years. Toronto-Dominion Bank (New York Branch), SEC No-Action Letter (available Feb. 24, 1984, on LEXIS, Fedsec library, Noact file) (certificates of deposit with maturities up to seven years, $100,000 minimum principal amount); Merrill Lynch, Pierce, Fenner & Smith Inc., SEC No-Action Letter (available Dec. 15, 1983, on LEXIS, Fedsec library, Noact file) (certificates of deposit with maturities up to seven years, $25,000 minimum principal amount in the case of branches and $100,000 minimum principal amount in the case of agencies, issued by New York branches and agencies of various foreign banks).

364. Moreover, it seems clear that the imposition of a limitation on the maturity of debt securities issued by a branch or agency of a foreign bank would not appear to serve any legitimate interest promoted by Section 3(a)(2) of the Securities Act. The rationale for permitting a branch or agency of a foreign bank to be accorded the status of a "bank" under Section 3(a)(2) is that the nature and extent of the regulation and supervision of the branch or agency provides protections equivalent to those to which United States banking institutions are subject. Once this determination has been made, the maturity or other characteristics of the debt securities issued by the branch or agency should not impact on the exempt status of the securities under Section 3(a)(2).

b. *The Exchange Act*

For purposes of Exchange Act registration requirements, a foreign bank would be the issuer of any securities issued by its United States branch or agency. Since the provisions of Section 12 of the Exchange Act apply only to equity securities or to debt securities listed on a United States exchange, the type of debt instruments normally issued by a branch or agency would not subject the foreign bank to registration under the Exchange Act or to the continuous reporting requirements of Section 13 of the Exchange Act.[365] Moreover, since securities issued by the branch or agency generally would not require registration under the Securities Act, the foreign bank generally would not become subject to the continuous reporting requirements of Section 15(d) of the Exchange Act.[366]

c. *The Investment Company Act*

Section 3(c)(3) of the Investment Company Act excludes from the definition of "investment company" any bank, which is defined by Section 2(a)(5) to include "(A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, . . . [or] (C) any other banking institution . . . doing business under the laws of any State or the United States . . . and which is supervised and examined by State or Federal authority having supervision over banks. . . ."[367]

Although United States branches and agencies of foreign banks have received no-action letters recognizing their status as "banks" for purposes of the Securities Act,[368] they have not received a similar

365. If securities of a foreign bank that has a United States branch insured by the Federal Deposit Insurance Corporation [hereinafter cited as the FDIC] are subject to the registration requirements of Section 12(b) or 12(g) of the Exchange Act, the bank must register the securities and file reports with the FDIC pursuant to Section 12(i) of the exchange Act. This Section provides that, with respect to securities issued by insured banks, the federal banking authorities are charged with the responsibility for administering the applicable provisions of the Exchange Act and for adopting regulations comparable to those of the SEC. In this regard, the FDIC has promulgated regulations governing the registration and reporting requirements for foreign banks with insured branches. *See* 12 C.F.R. Part 335 (1985).

366. For a discussion of the Exchange Act registration and reporting requirements applicable to foreign banks, see *supra* notes 140-46 and 154-57.

367. 15 U.S.C. § 80a-2(a)(5) (1984).

368. *See, e.g.*, Union Bank of Switzerland, SEC No-Action Letter (available Dec. 26, 1979, on LEXIS, Fedsec library, Noact file); Mitsui Bank (Canada) Ltd., SEC No-Action Letter (available Oct. 15, 1979, on LEXIS, Fedsec library, Noact file); Royal Bank of Canada, SEC No-Action Letter (available Apr. 9, 1979, on LEXIS, Fedsec library, Noact file); Fuji Bank, Ltd., SEC No-Action Letter (available Mar. 2, 1978, on LEXIS, Fedsec library, Noact file). *See also supra* notes 351-64 and accompanying text.

no-action position with respect to the Investment Company Act. While, as one commentary has noted, the SEC appears to have received no requests for such letters, the SEC's possible acceptance of the view that such branches and agencies are "banks" under the Investment Company Act may be inferred from the staff's failure to raise objections under the Investment Company Act to issuances of securities by United States branches and agencies of foreign banks.[369]

When a foreign bank that has received a Section 6(c) exemption subsequently establishes a United States branch or agency, the question arises as to whether issuance of securities by that branch or agency is governed by the Section 6(c) representations of the foreign bank. Under the foregoing analysis, it seems reasonable to conclude that those prior representations are inapplicable to the United States branch or agency since it, unlike the foreign bank, should be deemed to be a "bank" under the Investment Company Act and does not itself need the Section 6(c) exemption in order to issue securities in the United States.[370]

In two no-action letters issued a number of years ago, the SEC staff took the position that the exception from the Investment Company Act available to a branch or agency of a foreign bank may be shared by the foreign bank itself. Two Israeli banks with banking operations in the United States have received no-action letters in which their status as "banks" under subparagraph 2(a)(5)(C) and for purposes of the Section 3(c)(3) exception was acquiesced in by the staff of the SEC. In their no-action requests the banks argued that they were supervised within the United States through their United States banking subsidiaries, branches and agencies.[371] Since 1976, no responses to no-action requests have been published by the SEC staff which either accept or reject this analysis, and it is diffi-

369. *See* Gruson & Jackson, *supra* note 61, at 198-99 n.82.

370. A member of the SEC staff has indicated that he takes the contrary position and that a branch issuing securities in the United States would be required to comply with representations made by the foreign bank parent with respect to a prior Section 6(c) exemption.

371. Bank Leumi le-Israel B.M., SEC No-Action Letter (available Aug. 27, 1976, on LEXIS, Fedsec library, Noact file) (United States banking subsidiary, branch, and agencies); Israel Discount Bank Ltd., SEC No-Action Letter (available Mar. 2, 1974, on LEXIS, Fedsec library, Noact file) (United States banking subsidiary and agency). The SEC staff took a no-action position in each case with respect to counsel's opinion that the supervision of the foreign bank itself incident to the state supervised operation of its New York branches, agencies or banking subsidiaries, combined with the supervision of the parent foreign bank in its home country, was sufficient to bring that foreign bank within the bank definition of Section 2(a)(5)(C) of the Investment Company Act. *See* Gruson & Jackson, *supra* note 61, at 223-26.

cult to conclude at this date that the no-action letter authority may still be relied upon.

3. *Federal Banking Law Reserve Considerations*

The Federal Reserve Board's Regulation D requires a branch or agency of a Foreign Bank to maintain reserves against its "deposits" if its foreign parent bank (together with certain affiliated companies) has total world-wide consolidated bank assets in excess of $1 billion[372] or the branch is eligible for federal deposit insurance.[373]

"Deposit" is broadly defined in Regulation D and includes many obligations of a depository institution.[374] A certificate of deposit issued by a branch or agency of a foreign bank would clearly be viewed as a deposit under Regulation D.[375] In addition, since Regulation D defines "deposit" to include "[a]ny liability of a depository institution on any promissory note" except certain specified types of obligations, commercial paper and other evidences of indebtedness issued by a branch or agency of a foreign bank generally would be subject to the Regulation D reserve requirements.[376]

The Federal Reserve Board's Regulation D also provides generally that the obligation of a depository institution with respect to a bankers' acceptance would be viewed as a reservable deposit.[377] Regulation D specifically provides, however, that the obligation of a depository institution arising out of the creation, discount and subsequent sale by a depository institution of an Eligible Acceptance would not be subject to Regulation D reserve requirements.[378]

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372. 12 C.F.R. § 204.1(c)(2) (1985). *See supra* note 304 and accompanying text.

373. *Id. See supra* note 302.

374. 12 C.F.R. § 204.2(a)(1) (1985). While most debt obligations issued by a depository institution would be viewed as deposits subject to the Federal Reserve Board's Regulation D, various exceptions to this general rule do exist. For example, an obligation that is issued and held for the account of an office located in the United States of another depository institution, foreign bank, Edge Corporation or New York Investment (Article XII) Company is not viewed as a deposit for purposes of Regulation D. *Id.* § 204.2(a)(1)(vii)(A)(1). This exception is known as the "interbank exemption" and generally provides that obligations issued by one depository institution and held by another depository institution would not be viewed as deposits for purposes of Regulation D. The most common example of such an interbank transaction would be a "Fed-funds" transaction where funds on deposit in a Federal Reserve Bank held for the account of a particular depository institution are "purchased" or borrowed by another depository institution. For other exceptions to the definition of deposit under Regulation D, see *id.* § 204.2(a)(1)(vii); *id.* § 204.2(a)(2).

375. *Id.* § 204.2(a)(1)(i).

376. *Id.* § 204.2(a)(1)(vii).

377. *Id.* § 204.2(a)(1)(vii) and (viii).

378. *Id.* § 204.2(a)(1)(vii)(E). For a discussion of what constitutes an eligible bankers' acceptance, see *supra* text accompanying notes 314-28.

As discussed above, a branch or agency of a foreign bank may wish to issue letters of credit in support of the obligations of a third party. Although the definition of deposit under Regulation D is broad enough to encompass almost any type of obligation of a depository institution, Regulation D specifically provides that an obligation that represents a "conditional, contingent or an endorser's liability" would not be viewed as a "deposit" for purposes of Regulation D.[379]

Because a letter of credit issued by a branch or agency of a foreign bank would appear to represent a conditional or contingent liability of such branch or agency, it would appear that such a letter of credit should not, under the plain language of Regulation D, be viewed as a reservable liability of such branch or agency. The Federal Reserve Board, however, has taken the position orally that a contingent or conditional obligation undertaken by a depository institution subject to Regulation D with respect to debt securities of an affiliate would, despite the literal terms of Regulation D, be a reservable deposit of the depository institution subject to Regulation D. As a result, letters of credit issued by a branch or agency of a foreign bank in support of debt securities issued by an affiliate might be viewed as a reservable liability of the branch or agency.[380]

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379. 12 C.F.R. § 204.2(a)(2)(ii) (1985).

380. In a related area, it should be noted that, in a letter dated July 29, 1983, an Associate General Counsel of the Federal Reserve Board expressed the view that a United States bank which guarantees the obligations of its Schedule B Canadian bank affiliate must maintain reserves under Regulation D in respect of its obligations under the guarantees if the guarantees are payable in the United States. A Schedule B Canadian bank is a bank organized under the laws of Canada, which, among other things, is owned by one or more non-Canadian banks. Banks and Banking Law Revision Act, 1980, Section 304(4). This view, which presumably would apply also if the guarantee were issued by a United States branch or agency of a foreign bank, is premised on Section 204.1(c)(5) of the Federal Reserve Board's Regulation D, which provides that no reserves need be maintained by a depository institution subject to Regulation D with respect to a deposit liability of such depository institution if the deposit is payable only at an office of the depository institution located outside of the United States. 12 C.F.R. § 204.1(c)(5) (1985). In the Schedule B bank context, the Associate General Counsel appears to be taking the position that because the guarantee by the United States bank of the obligations of its Schedule B bank affiliate is payable within the United States, the guarantee should be a reservable obligation of the United States bank.

This view appears to be incorrect. Section 204.1(c)(5) of Regulation D was promulgated to put the overseas operations of United States depository institutions on a more competitive footing with foreign banks overseas. Prior to the enactment of the Section, a United States depository institution subject to Regulation D was required to maintain reserves against the deposit liabilities of an overseas branch or office of such United States depository institution because (i) the deposit liability was an obligation of the United States depository institution and (ii) the United States depository institution received the funds. In response to the concern that maintaining reserves increased the cost of raising funds for use in overseas operations, Section 204.1(c)(5) was adopted to provide that no reserves would be required to be main-

III. Registration Under the Securities Act and the Exchange Act

Set forth below is a discussion of the disclosure requirements applicable to registered offerings under the Securities Act and to the registration and reporting requirements under the Exchange Act.[381] As discussed above, short-term debt instruments and any debt that is issued by a branch or agency of a foreign bank may be exempt from registration under the Securities Act. Moreover, the Exchange Act registration requirements apply only to equity securities or to debt securities listed on a United States exchange. Accordingly, the disclosure requirements and concerns discussed in this Section will arise largely in the context of equity or long-term debt securities issued in the United States by a foreign bank or its finance or other subsidiary.[382]

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tained in respect of a deposit so long as the deposit was payable solely at an office located outside of the United States.

Reliance by the Associate General Counsel of the Federal Reserve Board on the above authority is misplaced in the Schedule B bank context. As indicated above, Section 204.1(c)(5) relates to the liabilities of a foreign branch or office of a United States depository institution subject to Regulation D. Foreign branches and offices are not separate legal entities from the depository institution of which they are a part. The deposit liabilities of the foreign branch or office are, accordingly, the deposit liabilities of the United States depository institution and the funds received by the branch are assets of the United States depository institution. The analysis is materially different, however, in the context of a Schedule B bank.

A Schedule B bank is a separate legal entity formed as a subsidiary or an affiliate of a non-Canadian depository institution. The deposit liabilities of the Schedule B bank are its separate corporate liabilities and are, therefore, not liabilities of a United States depository institution subject to Regulation D. In addition, the funds obtained through the issuance by the Schedule B bank of its obligations are not, to the author's knowledge, made available to the United States depository institution with which the Schedule B bank is affiliated. In this case, therefore, no provision of Regulation D would define either the obligation of the Schedule B bank or the guarantee of the United States depository institution as a "deposit" subject to the reserve maintenance requirements of Regulation D.

In this regard, if the funds received by Schedule B banks upon issuance of its obligations were made available to a United States depository institution subject to Regulation D, the Schedule B bank's obligations would constitute a reservable "deposit." Section 204.2(a)(1)(v) provides in pertinent part that a "deposit" means "[a]ny liability of a depository institution's affiliate . . . to the extent that the proceeds are used to supply or maintain the availability of funds . . . to the depository institution, except any such obligation that, had it been issued directly by the depository institution, would not constitute a deposit." *Id.* § 204.2(a)(1)(v).

381. Although not discussed in this section, a foreign bank must have received an exemption from registration under the Investment Company Act. *See supra* note 206 and accompanying text.

382. Securities issued by a United States operating subsidiary that are not guaranteed by its foreign parent will be subject to the registration and disclosure requirements for domestic issuers, a subject which is beyond the scope of this article.

A. *Registration Statement Forms*

1. *Integrated Disclosure System*

In 1982, the SEC promulgated a comprehensive revision of its disclosure requirements for foreign private issuers, including foreign banks, which publicly offer securities, or have securities traded, in the United States.[383] This action was part of an overall effort by the SEC to simplify and clarify its disclosure requirements for all issuers and to integrate the disclosures required in registered offerings under the Securities Act with disclosures required as part of the continuous reporting requirements under the Exchange Act.[384]

The integrated disclosure system for foreign private issuers was structured around (i) a registration and annual report form under the Exchange Act, Form 20-F,[385] and (ii) three registration forms under the Securities Act, Forms F-1, F-2, and F-3.[386] The three Securities Act forms differ in their eligibility criteria, in the types of transactions for which they may be used, and in the degree to which

383. SEC Securities Act Release No. 6437 (Nov. 19, 1982), 47 Fed. Reg. 54,764 (1982, *reprinted in* 5 FED. SEC. L. REP. (CCH) ¶ 72,407, at 62,031. The SEC determined to adopt separate registration forms for foreign issuers to accommodate certain foreign disclosure practices. In recognition of the increasing numbers of issuers that are raising capital through public offerings of securities outside their home countries, the SEC has issued a release inviting comment on two conceptual approaches designed to facilitate multi-national offerings in the United States, the United Kingdom, and Canada. SEC Securities Act Release No. 6568 (Feb. 28, 1985), 50 Fed. Reg. 9,281 (1985), *reprinted in* [1984-1985 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,743, at 87,318. The two methods being considered to facilitate multi-national offerings are (i) an agreement among the three participating countries that a prospectus accepted in an issuer's domicile and meeting certain minimum standards would be accepted for offerings in each of the other participating countries, and (ii) an agreement among the three countries as to uniform disclosure standards for an offering document that could be simultaneously filed with each of the country's respective securities administrators.

384. The goal of integrated disclosure under the Securities Act and the Exchange Act is to eliminate duplicative disclosure and dissemination requirements whenever possible to reduce burdens on issuers and to provide more meaningful and readable disclosure to investors. The manner in which the SEC has sought to achieve this goal is predicated on two fundamental determinations. First is the SEC's conclusion that, if information about an issuer is material, then generally it will be material both in the initial distribution of securities and in the secondary trading markets. Second is the SEC's determination that information regularly furnished to the marketplace through Exchange Act reports and reflected in the price of an issuer's outstanding securities need not always be reiterated in a prospectus for purposes of a distribution of securities under the Securities Act. *See, e.g.*, SEC Securities Act Release No. 6383 (Mar. 3, 1982), 47 Fed. Reg. 11,819 (1982), *reprinted in* [Transfer Binder for Accounting Releases] FED. SEC. L. REP. (CCH) ¶ 72,328, at 62,990.

385. 17 C.F.R. § 249.220F (1985). The official text of Form 20-F is set forth at 4 FED. SEC. L. REP. (CCH) ¶ 29,701.

386. 17 C.F.R. § 239.31-239.33 (1985). The official text of Forms F-1, F-2 and F-3 is set forth at 2 FED. SEC. L. REP. (CCH) ¶¶ 6951, 6961 and 6971, respectively.

information is permitted to be incorporated by reference from an issuer's Form 20-F rather than set forth in the registration statement. In general, issuers that have regularly disseminated information to the marketplace on Form 20-F for at least three years need not repeat the Form 20-F information in any filing made under the Securities Act. The disclosure system for foreign private issuers also includes a registration form under the Securities Act for ADRs, Form F-6,[387] and a new registration form for certain merger and exchange offer transactions, Form F-4.[388]

2. *Form 20-F*

Form 20-F serves both as a registration statement for securities under Section 12 of the Exchange Act and as the annual report for foreign private issuers, including foreign banks, subject to the continuous reporting requirements of the Exchange Act. In addition, it serves as the cornerstone of the SEC's integrated disclosure system for foreign private issuers since, as the basic disclosure document for foreign issuers, it may be incorporated by reference into certain registration statements under the Securities Act. Form 20-F is available for use by all non-Canadian foreign private issuers and by certain Canadian issuers who have not taken voluntary steps to enter the United States markets.[389]

Although the disclosure required by Form 20-F generally is comparable to that for domestic issuers, there are several areas in which the disclosure requirements for foreign issuers are less stringent.[390] For example, Form 20-F requires disclosure of beneficial owners of

387. 17 C.F.R. § 239.36 (1985). The official text of Forms F-6 is set forth at 2 FED. SEC. L. REP. (CCH) ¶ 7001. *Id.* § 239.36.

388. 17 C.F.R. § 239.34 (1985). The official text of Forms F-6 is set forth at 2 FED. SEC. L. REP. (CCH) ¶ 6981.

389. 17 C.F.R. § 249.220f(b) (1985). For the definition of "foreign private issuer," see *supra* note 23.

390. Form 20-F is divided into four parts. Part one requires a general description of the registrant, including information about the registrant's business and properties, its officers and directors, the trading market for its securities, selected financial data and management's discussion and analysis of registrant's financial condition, and foreign governmental laws and regulations affecting its security holders. Part two, which must be completed only if Form 20-F is being used as a registration statement, requires a description of the securities to be registered, which may include capital stock, debt securities, ADRs, and other securities, such as warrants. Part three, which must be completed only if Form 20-F is being used as an annual report, requires disclosure of any material defaults upon senior securities and changes in the rights of security holders that have not been previously disclosed in a report to the SEC. Part four requires disclosure of the registrant's financial statements and the filing of certain exhibits.

more than ten percent of the issuer's stock (rather than five percent as required of domestic issuers); this requirement is consistent with international guidelines and, therefore, conforms to the disclosures expected of foreign issuers.[391] Similarly, unlike the requirements for domestic issuers, Form 20-F requires that compensation of individual officers and directors be disclosed only if made public in the registrant's home country; otherwise, disclosure may be made on an aggregate basis.[392]

Form 20-F also contains somewhat different financial statement requirements than those generally required for domestic issuers. First, Form 20-F financial statements may be prepared in accordance with foreign generally accepted accounting principles if material variations from United States generally accepted accounting principles (U.S. GAAP) and from the uniform accounting rules established by the SEC in Regulation S-X[393] are disclosed and quantified.[394] Moreover, if the quantification would involve unreasonable effort or expense, Rule 12b-21 under the Exchange Act, which is referred to in General Instruction C(d) of Form 20-F, would permit the registrant to furnish only a textual discussion of the differences in accounting practices together with a statement showing that the quantification would involve undue effort or expense.[395]

Second, registrants on Form 20-F, at their option, may determine not to include certain supplemental disclosures required by U.S. GAAP and Regulation S-X.[396] Although this information is not required by Form 20-F, in many instances an issuer's use of certain registration statements under the Securities Act will be dependent on the issuer's having disclosed in its Form 20-F the full information required by U.S. GAAP and Regulation S-X.[397]

The form must be signed by an officer of the registrant on the registrant's behalf. If ADRs are being registered, the registration statement also must be signed by either the depositary or the legal entity created by the agreement for the issuance of the ADRs.

391. Item 4(c) of Form 20-F. *Cf.* 17 C.F.R. § 229.403 (1985).

392. Item 11 of Form 20-F. *Cf.* 17 C.F.R. § 229.402 (1985).

393. 17 C.F.R. Part 210 (1985).

394. Items 17-18 of Form 20-F.

395. 17 C.F.R. § 240.12b-21 (1985).

396. Item 17 of Form 20-F.

397. For a discussion of the disclosure problems raised by a foreign issuer's compliance with U.S. GAAP and Regulation S-X, see *infra* text accompanying notes 416-34.

3. *Securities Act Registration Statements*
a. *Forms F-1, F-2 and F-3*

Forms F-1, F-2, and F-3 are designed specifically for the registration of securities offered by foreign private issuers, including foreign banks, that are eligible to use Form 20-F.[398] In general, the three forms require the same total amount of disclosure. The chief difference among the forms is the degree to which the required disclosures must be set forth in the prospectus included in the registration statement as opposed to being incorporated by reference from the issuer's Form 20-F. Form F-1 requires that all specified information be set forth in the prospectus; Forms F-2 and F-3, on the other hand, permit the issuer's Form 20-F to be incorporated by reference into a short-form prospectus.[399]

Eligibility requirements for the registration forms depend upon, among other things, whether and how long an issuer has been subject to the continuous reporting requirements under the Exchange Act, whether the issuer has included full U.S. GAAP and Regulation S-X financial information in its Form 20-F, the type of securities offering proposed, and whether the issuer is a "world class issuer." A "world class issuer" is the term used by the SEC to refer,

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398. *See supra* text accompanying notes 389-97.

Although foreign banks that qualify as foreign private issuers should be permitted to use Forms F-1, F-2, and F-3, the SEC staff's position that foreign banks are investment companies for purposes of the Investment Company Act raises the possibility that foreign banks should register their securities offerings on the registration forms adopted under the Investment Company Act for use by investment companies registering securities under the Securities Act. *See supra* note 170. The disclosures required by these forms, however, appears more appropriate for investment companies required to register under the Investment Company Act than for foreign banks that have obtained an exemption from registration as an investment company pursuant to Section 6(c) of the Investment Company Act.

Although there is no specified registration form for foreign government issuers, Schedule B to the Securities Act specifies general disclosure requirements for the registration of securities issued by a foreign government or political subdivision thereof. 15 U.S.C. § 77aa (1982). In addition, the SEC has permitted foreign corporations, including banks, that are government owned to register under Schedule B if the corporation's securities are guaranteed by a foreign government or political subdivision. Disclosure contained in registration statements filed under Schedule B is considerably less detailed than is required of foreign private issuers and generally includes information about the issuer's form of government, the economy, monetary system, foreign trade, and foreign exchange of the issuer's home country, and various other economic financial factors affecting the issuer. Foreign government issuers are specifically exempt from the requirements of Regulation S-X, the SEC's uniform accounting rules for financial statements.

399. The registration statement must be signed by the registrant, its principal executive officer or officers, its principal financial officer, its controller or principal accounting officer, at least a majority of the board of the directors, and its authorized representative in the United States.

in the case of a particular offering, to a foreign private issuer that either (i) has an aggregate worldwide equity "float" (i.e., voting stock held by non-affiliates) of $300 million or more or (ii) in that offering is offering non-convertible debt securities that are "investment grade" (i.e., rated in one of the four highest rating categories for debt by a United States nationally recognized statistical rating organization).[400]

Form F-1 is the basic Securities Act registration form for foreign private issuers and is available for all transactions by issuers not eligible to use any other registration form. Information about the securities being offered, information about the offering transaction, and information about the issuer comparable to that required in Form 20-F must be set forth in the prospectus contained in the registration statement; no incorporation by reference is permitted.

Form F-2 permits the use of a short-form prospectus that contains information about the securities being registered and about the offering transaction. Information about the issuer, including the issuer's financial statements, need not be set forth in the prospectus but instead may be incorporated by reference from the issuer's Form 20-F. For all offerings except for rights offerings and other similar offerings to existing security holders, however, the financial statements in the issuer's Form 20-F must contain, or be amended to contain, the full information required by U.S. GAAP and Regulation S-X. In addition, the Form 20-F must be delivered to investors with the prospectus. Form F-2 is available for all transactions, except exchange offers, by issuers subject to the Exchange Act reporting requirements that either: (i) have been filing reports for at least three years and have timely filed all reports required to be filed during the past twelve months, (ii) are "world class" issuers and have filed at least one Form 20-F, or (iii) are making a rights or similar offering to existing security holders and have filed at least one Form 20-F. In addition, neither the registrant nor any of its subsidiaries, since the end of the last fiscal year for which certified financial statements were filed under the Exchange Act, may have (i) failed to pay any dividends or sinking fund installments on preferred stock or (ii) experienced material defaults on loans or long term leases.

Form F-3, like Form F-2, permits the use of a short-form prospectus that incorporates by reference from Form 20-F financial state-

400. *See* SEC Securities Act Release No. 6360 (Nov. 20, 1981), 46 Fed. Reg. 58,511 (1981), *reprinted in* [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,054, at 84,641 [hereinafter cited as Foreign Private Issuer Integrated Disclosure Release].

ments and other information about the issuer. Although the financial statements contained in the Form 20-F generally must include the full information required by U.S. GAAP and Regulation S-X, exceptions to this requirement exist for: (i) certain offerings to existing security holders and (ii) offerings of non-convertible investment grade debt securities. Unlike Form F-2, the Form 20-F need not be delivered to investors with the Form F-3 prospectus. Form F-3 is available for use only by "world class" issuers that have been subject to Exchange Act reporting requirements for at least three years and that have timely filed all reports required to be filed during the past twelve months. In addition, both the registrant and its subsidiaries must have satisfied the dividend, sinking fund, loan, and lease obligations specified in Form F-2. Form F-3 is available only for (i) primary offerings of securities for cash, (ii) secondary offerings, and (iii) rights offerings and certain other offerings to existing securities holders.[401]

A foreign bank's majority-owned subsidiary that would not otherwise be eligible to use a particular registration form for foreign private issuers may, nevertheless, use Form F-3 under the following two circumstances. First, if the foreign bank fully guarantees, as to principal and interest, the securities being registered, the subsidiary may use any registration form the foreign bank is eligible to use. In this event, the foreign bank is the issuer of a separate security, i.e., the

401. The SEC recently adopted a new registration form under the Securities Act, Form F-4, for use in business combination transactions involving foreign private issuers. *See supra* note 388. Form F-4 may be used by any foreign private issuer eligible to use Form 20-F for the purpose of registering securities issued in one or more of the following transactions: (i) a reclassification, merger, consolidation or acquisition of assets of the type described in Rule 145 under the Securities Act (17 C.F.R. § 230.145 (1985)); (ii) mergers in which the consent of security holders is not required; (iii) exchange offers; or (iv) resales of securities acquired in one of the above types of transactions.

Form F-4 extends the principles of integrated disclosure to business combination transactions involving foreign private issuers, including foreign banks, by permitting issuers eligible to use Forms F-2 or F-3 to incorporate information by reference from the issuer's Form 20-F generally to the same extent as would be permitted if the issuer were registering securities in a primary offering on Forms F-2 or F-3. Under certain circumstances, information about a company being acquired also could be incorporated by reference to Exchange Act reports. If an issuer relied on the incorporation by reference provisions of Form F-4, however, the prospectus would be required to be sent to security holders at least 20 days prior to the date a vote or consent would have to be given, an exchange offer was scheduled to expire, or a security holder's investment decision would otherwise become binding.

Use of Form F-4 for business combination transactions is optional. Some foreign banks might prefer to continue registering securities issued in business combinations on Form F-1 and to have the company being acquired, if it were subject to the SEC's proxy rules, prepare its own proxy statement. In that way, the company being acquired would assume the liability for information contained in its proxy statement.

guarantee, which may be registered concurrently on the same registration statement as the guaranteed securities of the subsidiary. Both the foreign bank and the subsidiary must disclose the information required by the registration form being used as if each were the only registrant, except that, if the subsidiary is a United States company that would not be eligible to file annual reports on Form 20-F after the effective date of the registration statement, it must disclose the information required by the applicable registration form for domestic issuers.[402] Second, a majority-owned subsidiary that is offering non-convertible investment-grade debt securities may use Form F-3 if its foreign bank parent is eligible to use that form, even though the foreign bank does not guarantee the securities.[403]

b. *ADR Registration*

As discussed previously, ADRs may be established to facilitate trading in a foreign bank's securities in the secondary market in the United States and, if an exemption is granted by the SEC, as part of a foreign bank's distribution of its securities in the United States. Since depository shares evidenced by ADRs are separate securities from the underlying deposited securities of the foreign bank, they must be registered separately under the Securities Act, unless an exemption is available.

In 1983 the SEC adopted Form F-6, which was specifically designed for the registration under the Securities Act of depositary shares represented by ADRs issued by a depositary against the deposit of securities of a foreign issuer.[404] This form includes a very brief prospectus containing information about the securities being registered, certain exhibits, and undertakings by the depositary to furnish information to the SEC and to make available certain documents to ADR holders. Form F-6 is available for use for the registration of depositary shares if: (i) the holder of the ADRs is entitled to withdraw the deposited securities at any time, subject only to certain temporary delays, the payment of certain charges, or compliance with certain laws or governmental regulations, (ii) the deposited securities are offered and sold in transactions registered under

402. General Instruction I to Forms F-1, F-2, and F-3, 17 C.F.R.

403. Instruction 6 to General Instruction I of Form F-3.

404. SEC Securities Act Release No. 6459 (Mar. 18, 1983), 48 Fed. Reg. 12,346 (1983), *reprinted in* [1982-1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,329, at 85,833 [hereinafter cited as Form F-6 Enacting Release]. *See supra* note 387. A registration statement pursuant to Form F-6 relates to depositary shares evidenced by ADRs, not to the foreign securities deposited with the depositary.

the Securities Act or exempt from registration, and (iii) unless the issuer of the deposited securities is concurrently registering the deposited securities, either the issuer must be subject to the reporting requirements of the Exchange Act or the deposited securities must be exempt therefrom by Rule 12g3-2(b) of the Exchange Act.[405]

c. *Delayed or Continuous Offerings*

Securities registered under the Securities Act generally are offered to the public after a registration statement for the securities is filed with the SEC but before it is declared effective. Based on indications of interest received during this time, the securities generally are sold within a short time after the registration statement is declared effective. Provided the conditions of Rule 415 under the Securities Act are satisfied, however, certain registered offerings (shelf registrations) may be offered and sold on a delayed or continuous basis after the effectiveness of the registration statement.[406]

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405. *See infra* notes 152-53 and accompanying text. As the staff of the Division of Corporation Finance noted, "In rare instances, ADR arrangements have been established for debt securities. In these circumstances, 'even though Section 12(g) of the Exchange Act applies only to equity securities,' the Commission would expect a foreign issuer to register under Section 12 or establish the exemption permitted by Rule 12g3-2(b)." Form F-6 Enacting Release, n.3.

The Form F-6 registration statement must be signed by the legal entity created by the agreement for the issuance of the ADRs. Although the depositary may sign on behalf of the legal entity, Form F-6 provides that the depositary will not be deemed either an issuer, a person signing the registration statement, or a person controlling the issuer for purposes of liability under the Securities Act. *See supra* notes 134-38 and accompanying text. If the ADR arrangement is sponsored by a foreign bank issuer of the deposited securities, the registration statement also must be signed by the foreign bank, by specified officers and directors of the foreign bank, and by the foreign bank's authorized representative in the United States.

Pursuant to Rule 466 under the Securities Act, which can be used only under the following conditions, a depositary filing a registration statement on Form F-6 may designate a date and time for the registration statement to become effective automatically. 17 C.F.R. § 230.466(a) (1985). First, the depositary must have filed a prior registration statement on Form F-6, which the SEC has declared effective, with identical terms of deposit other than the number of securities represented. Second, the designation of the effective date and time must be set forth on the facing page of the Form F-6 registration statement.

As an alternative to registration on Form F-6, depositary shares evidenced by ADRs may be registered on any other form used to register the underlying deposited shares, including Forms F-1, F-2, or F-3, provided the information required by Form F-6 is contained therein. As with Form F-6, the registration statement must be signed by the depositary or legal entity created by the ADRs as well as by the issuer of the underlying securities.

406. *See* 17 C.F.R. § 230.415 (1984). Foreign government owned banks registering securities pursuant to Schedule B of the Securities Act may take advantage of a modified "shelf" procedure similar to that available to foreign private issuers under Rule 415 of the Securities Act. SEC Securities Act Release No. 6424 (Sept. 2, 1982), 47 Fed. Reg. 39,809 (1982), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 3850A, at 3377.

The relevant types of securities for which Rule 415 permits an issuer to maintain a shelf registration include the following: (i) depository shares registered on Form F-6;[407] (ii) securities registered on any available form, the offering of which will be commenced promptly, will be made on a continuous basis, and may continue for more than 30 days after the effectiveness of the registration statement;[408] (iii) securities issued upon the exercise or conversion of other outstanding securities;[409] (iv) securities issued in connection with business combination transactions;[410] and (v) securities registered or qualified to be registered on Form F-3, to be offered and sold on a delayed or continuous basis by or on behalf of the registrant or the registrant's parent or subsidiary.[411] The latter procedure, available only to issuers eligible to use Form F-3, permits the issuer to register any amount of debt or equity securities that it reasonably expects to sell within two years and keep the registered securities "on the shelf" until market conditions are favorable.[412]

4. *Consent to Service of Process*

To facilitate service of process on foreign issuers for liabilities arising out of their activities in the United States, Section 6(a) of the Securities Act and the registration forms thereunder require that a foreign private issuer designate an agent in the United States to receive service of process and that this authorized representative sign the registration statement. Although not specified by SEC rules or regulations, the SEC staff generally requires that the agent be an employee of the registrant, an affiliated company (other than a shell corporation), or the underwriter or legal counsel in the United States for the offering.[413]

In addition, as a condition to exemptions granted to foreign banks under the Investment Company Act, the issuers generally are re-

407. 17 C.F.R. § 230.415(a)(1)(vi) (1985).

408. *Id.* § 230.415(a)(1)(ix).

409. *Id.* § 230.415(a)(1)(iv).

410. *Id.* § 230.415(a)(1)(viii).

411. *Id.* § 230.415(a)(1)(x).

412. Rule 415 imposes two additional conditions, however, if the securities being registered pursuant to this procedure are equity securities offered "at the market," i.e., offered into an existing trading market at fluctuating prices or through an exchange or market-maker in the securities. First, the amount of voting securities being registered must not exceed ten percent of the issuer's outstanding voting stock held by persons not affiliated with the issuer. Second, the offering must be sold through an underwriter or underwriters named in the prospectus. *Id.* § 230.415(a)(4).

413. Foreign Private Issuer Integrated Disclosure Release, *supra* note 400, at 84654.

quired to consent to service of process and authorize an agent in the United States to accept service. Although there are no comparable provisions in connection with Exchange Act filings, the securities rating agencies that rate securities of foreign private issuers also require consents to service as a condition to providing a rating.[414]

From time to time, the SEC has expressed concern about the difficulties that it and the courts have had in enforcing the federal securities laws against foreign persons. Despite the fact that these problems generally have arisen in connection with foreign issuers that have not filed registration statements with the SEC, the SEC has suggested that the consent to service requirements should be strengthened and has invited public comment on what steps should be taken in this area under both the Securities Act and the Exchange Act.[415]

B. *Principal Disclosure Considerations*

1. *Regulation S-X and Regulation S-K*

An important part of the SEC's integrated disclosure systems for both domestic and foreign issuers are Regulation S-K[416] and Regula-

414. In addition, in connection with small offerings pursuant to Regulation A under the Securities Act, a foreign issuer and each of its officers and directors that is not a resident of the United States must consent to service of process and designate the SEC as agent to receive service. 17 C.F.R. § 230.262 (1985).

415. Foreign Private Issuer Integrated Disclosure Release, *supra* note 400. In addition, the SEC has published for public comment a release discussing the possibility of enacting legislation that would provide for "waiver by conduct" of foreign secrecy laws. SEC Exchange Act Release No. 21,186 (July 30, 1984), 49 Fed. Reg. 31,300 (1984), *reprinted in* [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,648, at 86,976. Under this concept, a purchase or sale of a security in the United States by a person in a foreign country would be deemed an implied consent to the disclosure of information and evidence relevant to the transaction for the purposes of any SEC investigation, administrative proceeding, or action for injunctive relief authorized by the federal securities laws in connection with the transaction. It would also be deemed a consent to the exercise of *in personam* jurisdiction by United States courts and the SEC and the appointment of the United States broker that executed the transaction as agent for service of process or subpoenas.

As the SEC recognized, however, if the person were a foreign issuer located in a country that had blocking laws, the SEC might be prevented from obtaining relevant evidence regardless of the issuer's obligations under United States law. The SEC specifically requested comment on methods by which it might prevent blocking statutes from impeding its efforts to obtain evidence.

416. Regulation S-K contains the standard disclosure requirements applicable to the nonfinancial portions of registration statements and other documents filed under the Securities Act and the Exchange Act. *See* 17 C.F.R. §§ 229.10-.802 (1985).

tion S-X.[417] Generally, the SEC's registration forms and other disclosure forms refer to specific items in Regulation S-K and Regulation S-X for the substantive disclosure requirements of the particular form. When promulgating the disclosure system for foreign private issuers, however, the SEC recognized that, in many instances, the contents of these regulations are more appropriate to domestic issuers than to foreign issuers.[418] As a result, the disclosure forms for foreign private issuers specify separately much of the information that foreign private issuers must disclose in response to the forms and generally refer to Regulation S-X and Regulation S-K only if the information to be disclosed is the same for both domestic and foreign issuers.

Complying with the disclosure provisions of Regulation S-K and Regulation S-X may present special problems for certain foreign banks filing disclosure documents under either the Securities Act or the Exchange Act. For example, as discussed above, financial statements in full compliance with Regulation S-X are encouraged in Form 20-F under the Exchange Act and, except for offerings of non-convertible investment grade debt securities registered on Form F-3 and certain offerings to existing security holders, are required in registration statements under the Securities Act. Possibly troublesome requirements are that financial statements comply with U.S. GAAP, with United States generally accepted auditing standards (U.S. GAAS), and with the special provisions of Regulation S-X and Regulation S-K applicable to banks and bank holding companies and the requirement that auditors satisfy certain independence standards. Although a discussion of accounting requirements generally is beyond the scope of this article, some of the more relevant considerations are set forth below.

2. *Accounting Concerns*

a. *Accounting Principles*

Regulation S-X and the registration forms for foreign private issuers generally require that financial statements filed with the SEC under both the Exchange Act and the Securities Act must be prepared in accordance with U.S. GAAP.[419] There may be numerous

417. Regulation S-X consists of uniform accounting rules governing the form and content of financial statements contained in documents filed under the federal securities laws. *Id.* §§ 210.1-01 to .12-30.

418. Foreign Private Issuer Integrated Disclosure Release, *supra* note 400.

419. *See, e.g.*, 17 C.F.R. § 210.1-01(a) (1985).

differences between U.S. GAAP and the generally accepted accounting principles of a foreign bank's home country (foreign GAAP).[420]

In recognition of these differences, Form 20-F under the Exchange Act and Forms F-1, F-2, and F-3 under the Securities Act permit foreign banks and other foreign private issuers to prepare financial statements in accordance with foreign GAAP. In this event, however, the disclosure must include a discussion of the material variations from U.S. GAAP and Regulation S-X and a quantification of the variations. To provide the necessary quantification, a foreign bank may be required, in essence, to prepare for internal use a separate set of financial statements substantially in compliance with U.S. GAAP and Regulation S-X.[421]

i. *Hidden Reserves*

The practice of hidden reserves, which is permitted in many foreign jurisdictions, illustrates the possible conflict between United States and foreign accounting principles. Hidden reserves are particularly relevant to foreign banks since they have most often been associated with the use and support of the practice.

A hidden reserve involves the creation of a financial statement account against which current losses may be charged; neither the account nor the charge against the account need be disclosed in publicly available financial statements. The intended effect of the hidden reserve is to smooth out the current statement of income by creating reserves in years of high income and charging losses against this reserve in the year in which they occur. The hidden reserve is created by one of three principal methods: undervaluing assets; overstating

420. Some frequently encountered areas in which there may be accounting differences between U.S. GAAP and foreign GAAP of a particular country include "pooling of interest" accounting in connection with mergers and consolidations; provision for liabilities for income taxes; provision for deferred taxes; existence of legal reserves with respect to which there may be restrictions as to use; rates of depreciation; valuation of fixed assets; reflection in balance sheets or in footnotes thereto of acceptances, guarantees, letters of credit, endorsements and other commitments on behalf of customers; treatment of "goodwill"; consolidation of subsidiaries for accounting and tax purposes; treatment of pension costs; valuation of investment account securities; and the method of determining provision for loan losses and of charging loan losses. *See, e.g.*, MOSTOFF & SPENCER, *United States Regulation of International Securities Transactions* in INTERNATIONAL FINANCIAL LAW 136 (R. Rendell ed. 1980) [hereinafter cited as MOSTOFF & SPENCER].

421. Rule 12b-21 under the Exchange Act would permit a registrant on Form 20-F to omit the quantification if it would require unreasonable effort or expense. *See supra* note 396 and accompanying text.

contingencies or liabilities; or establishing a general purpose reserve account by understating current income.[422]

In contrast, U.S. GAAP does not permit the creation or use of hidden reserves. Thus, although the financial statements of a foreign bank may have hidden reserves according to local accounting practices, for purposes of conforming the financial statements to U.S. GAAP or disclosing the differences between foreign GAAP and U.S. GAAP in a filing with the SEC, the hidden reserves would have to be disclosed in the United States.[423] As a result, when deciding whether to register securities in the United States under the federal securities laws, a foreign bank must determine whether disclosure of hidden assets or other similar accounting practices that differ from U.S. GAAP is acceptable to it.

ii. *Segment Reporting*

Another area of particular concern to many foreign private issuers is the disclosure of segment information. The nature of segment disclosure generally is governed by U.S. GAAP, as set forth in Statement of Financial Accounting Standards No. 14 (SFAS 14), which requires both industry and geographic segment information.[424]

An industry segment is a business component of the issuer that provides a group of related products and services to customers. Each segment generally is required to be reported upon separately if its revenues, operating profit (or loss) or identifiable assets constitute ten percent or more of the issuer's combined revenues, operating profit (or loss) or assets, respectively, for all industry segments. For each reportable industry segment, information concerning revenues, profitability, and assets must be set forth.[425]

Regardless of whether an issuer must present industry segment information, it is required to make geographic segment disclosures if either the revenues generated by or identifiable assets of its foreign operations constitute ten percent or more of its consolidated revenues or total assets, respectively. At a minimum, the issuer must break down revenues, profitability, and identifiable assets between its domestic and foreign operations. In addition, if the issuer's foreign operations are conducted in two or more geographic areas, such infor-

422. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PROFESSIONAL ACCOUNTING IN 30 COUNTRIES 672-73 (1975).

423. *Id.*

424. SFAS 14, "Financial Reporting for Segments of a Business Enterprise" (Dec. 1976).

425. SFAS 14, §§ 10, 15.

mation must be presented separately for each foreign geographic area that independently meets the above ten percent revenues or assets tests.[426]

In addition, foreign bank registrants under the Securities Act are subject to certain specialized industry disclosure provisions that require various segment reporting requirements. These provisions include Article 9 of Regulation S-X, which governs both foreign and domestic bank holding companies,[427] and Industry Guide 3 under both the Securities Act and the Exchange Act, which requires statistical disclosure by bank holding companies.[428]

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426. SFAS 14, § 32.33. Foreign issuers registering securities under the Securities Act generally must provide all financial information required by U.S. GAAP and Regulation S-X, including the above segment information. *See supra* notes 400-41. Limited exceptions to this requirement exist for issuers (i) making rights offerings, conversions and dividend or investment plan offerings to existing security holders or (ii) offering investment grade non-convertible debt securities registered on Form F-3. An exception similarly exists for issuers filing a Form 20-F under the Exchange Act which is not to be incorporated into a Securities Act registration statement. In these instances, most foreign private issuers would be required to disclose only modified segment information. Form 20-F, Item 1(a)(4), 17.

427. Article 9 of Regulation S-X specifies the terms that must appear on the income statements and balance sheets of a bank holding company and in the notes thereto, and requires geographic segment information for operations outside the United States separate from that required by SFAS 14. *See* 17 C.F.R. §§ 210.9-01 to 9-07 (1985).

428. *See* Instruction to Item 1(b) of Form 20-F; 17 C.F.R. § 229.801(c), 802(c) (1985). Industry Guide 3 is specifically applicable to foreign issuers to the extent the requested information is available without unwarranted or undue expense or burden. General Instruction 6 to Securities Act Guide 3, *id.* § 229.801(c). *Id.* §§ 210.9-01 to 9-07. Pursuant to this guide, a foreign bank is required to disclose, in tabular form, various information relating to an average balance sheet and analysis of net interest earnings, investment and loan portfolios, loan loss experience, deposits, return on equity and assets, and short-term borrowings. The information requested by Industry Guide 3 must be given for three or, in some cases, five years. In addition, if a foreign bank's assets, revenue, income (loss) before income tax expense or net income (loss) associated with foreign activities exceed 10 percent of those categories in the financial statements, the disclosures required by Industry Guide 3 generally must be set forth separately for foreign and United States activities.

As an alternative to the tabular presentation specified by Industry Guide 3, issuers may prefer to include the required disclosure in the management's discussion and analysis of financial condition and results of operation section of a filing under the Exchange Act or Securities Act. Form 20-F, Item 9, *id.* This section requires that management analyze the issuer's financial condition over the past three years in at least three areas—liquidity, capital resources and results of operations. Within each area of discussion, favorable or unfavorable trends and the identification of significant events or uncertainties must be emphasized. Foreign private issuers also are required to discuss pertinent governmental economic fiscal, monetary, or political policies or factors that have materially affected or could materially affect their operations or investments by United States persons.

b. *Auditing Standards*

An important requirement of Regulation S-X is that an issuer's auditors be independent of the issuer.[429] For purposes of this requirement, an auditing firm will not be deemed independent of a foreign bank if the firm or any of its members have a financial interest in the foreign bank or its affiliates or are connected with the foreign bank or its affiliates as an underwriter, director, officer, employee, or similar position. The SEC generally requires that foreign private issuers filing disclosure documents under the Securities Act or the Exchange Act that contain audited financial statements must comply with this independence requirement despite the fact that in many foreign countries this concept of independence does not exist.[430]

The SEC also requires assurance that a foreign issuer's auditors are familiar with U.S. GAAS and that these auditing standards have been properly applied. Two major areas in which U.S. GAAS may differ from foreign auditing standards involve the practices employed for confirming receivables and observing physical inventories.[431]

The SEC's insistence that foreign issuers comply with U.S. GAAS makes it advisable for a foreign bank to alert its auditors well in advance of any contemplated offering in the United States. In addition, a foreign bank may need to retain a new or additional auditor to satisfy the independence requirements of Regulation S-X and to be able to ensure that the audit is conducted in accordance with U.S. GAAS.

c. *Age of Financial Statements*

Regulation S-X contains special provisions relating to the age of audited financial statements of foreign private issuers eligible to use Form 20-F, pursuant to which foreign issuers are permitted to furnish financial statements that are older than those permitted for domestic issuers.[432] Under these provisions, foreign banks and other foreign private issuers may use financial statements up to six months old at the effective date of the registration statement or report being filed, unless the issuer prepares and discloses to its shareholders or

429. 17 C.F.R. § 210.2-01(b) (1985).

430. An exception for foreign governmental agencies exists which permits the issuer's financial statements to be examined by the regular and customary auditing staff of the respective government if public financial statements of such governmental agency are customarily examined by such staff. *Id.* § 210.2-03.

431. *See* MOSTOFF & SPENCER, *supra* note 420, at 137.

432. 17 C.F.R. § 210.3-19(b) (1985).

otherwise makes public more current interim financial information. If the filing is made subsequent to six full months after the end of the issuer's most recent fiscal year, the registrant must provide a balance sheet as of an interim date within six months of the effective date of the filing and statements of income and changes in financial position for the interim period; these interim reports need not be audited. In addition, foreign banks and other foreign private issuers may use financial statements up to one year old at the effective date of a registration statement for certain offerings to shareholders, such as rights offerings, conversions, or offerings pursuant to a dividend reinvestment plan.

d. *Currency and Convenience Translations*

Regulation S-X also contains special provisions relating to the currency of financial statements of foreign private issuers, pursuant to which a foreign bank issuer generally will be required to state its financial statements in the currency of its country of incorporation or organization.[433] A different currency may be used, however, provided three conditions are met: (i) the other currency is that of the foreign bank's primary economic environment (i.e., the environment in which the bank generates and expends cash); (ii) there are no material exchange restrictions or controls on the other currency; and (iii) the foreign bank publishes its financial statements for all of its shareholders in the other currency.

The currency in which the financial statements are prepared must be disclosed prominently on the face of the financial statements. Dollar equivalent convenience translations, which the SEC used to encourage, are no longer permitted to be presented, except that a translation may be presented of the most recent fiscal year and any subsequent interim period. The policy change concerning the disclosure of convenience translations resulted from the SEC's recognition that, in the environment of floating rates of exchange of national currencies, translating financial statements at a convenience exchange rate selected on an arbitrary date could be misleading because of the likely distortion of trends.[434]

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433. *Id.* § 210.3-20(a).

434. Greene & Ram, *Two SEC Actions Significantly Affect Foreign Issuers*, Legal Times, Dec. 6, 1982, at 25, col. 1.

IV. Blue Sky Issues

A. *Registration of Securities with States*

Each of the fifty states of the United States, and Puerto Rico, require some form of securities registration.[435] While a few states either require registration in only limited circumstances[436] or provide broad exemptive provisions making the necessity of securities registration unlikely,[437] the vast majority of state blue sky laws require the registration of securities absent a specific exemption. As a consequence of the blue sky laws, a foreign bank or an affiliate of a foreign bank that intends to offer and sell securities in a particular jurisdiction must either avail itself of an applicable exemption for the securities or register them.

With the exception of Pennsylvania and Montana, the blue sky laws do not provide an exemption specifically directed to securities issued by a foreign bank or its affiliates.[438] However, as in the case of the Securities Act, one or more of several possible exemptions may be applicable to securities issued or offerings made by such entities. These would include (i) securities exemptions for commercial paper

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435. The District of Columbia has a statute regulating securities activities but does not require securities to be registered. District of Columbia Securities Act, D.C. Code §§ 2-2601 to -2619 (1981).

436. The New York blue sky law requires intrastate offerings of securities (that is, those made exclusively in New York) to be registered but does not require interstate offerings of securities to be registered. N.Y. Gen. Bus. Law § 359-ff (McKinney 1984). It should be noted, however, that New York does require certain broker filings to be made in connection with certain interstate offerings. *Id.* § 359-e(2), (8). The Nevada blue sky law requires securities generally to be registered if they are offered to 150 or more persons in Nevada or sold to 34 or more persons within or without Nevada. Nev. Rev. Stat. § 90.075 (1979). Both New York and Nevada exempt from the above-described securities registration requirements any security registered or exempt from registration under the Securities Act other than pursuant to Section 3(a)(11) of the Act. N.Y. Gen. Bus. Law § 359-ff(5) (McKinney 1984); oral statements of officials of Nevada Department of State Securities Division, July 1984.

437. Under the Colorado Securities Act of 1981, offers and sales of securities not made exclusively in Colorado are exempt from registration. Colo. Rev. Stat. § 11-51-113(2)(o) (Supp. 1981).

438. The blue sky laws uniformly provide exemptions for securities issued by national banks and, subject to certain variations, for securities issued by United States state-chartered banks. In addition, the Division of Corporation Finance of the Pennsylvania Securities Commission will recommend to the Commission that it issue an interpretive opinion that a foreign bank's United States branch or agency be declared a "bank" for purposes of the state's bank-issued security exemption where the branch or agency is subject to the same degree of federal or state regulation and supervision as domestic banks. *See* Pennsylvania Securities Bulletins, 2 Blue Sky L. Rep. (CCH) ¶ 48,675. The Montana Securities Department has also indicated that it would grant exemptions from registration to the United States branch of a foreign bank upon the submission to the Department of a no-action request, including an opinion of counsel. 2 Blue Sky L. Rep. (CCH) ¶ 36,513.

and for securities listed on certain stock exchanges and (ii) transactional exemptions for securities sold to institutional investors and for securities sold in private placement transactions.[439]

Commercial Paper Exemption. Each of the blue sky laws exempts from the applicable securities registration requirements commercial paper meeting specified requirements. Although the commercial paper exemption varies in certain states, the vast majority of jurisdictions, including most of the jurisdictions which have adopted versions of the Uniform Securities Act, exempt from registration commercial paper if the paper (i) evidences an obligation to pay cash within 270 days from the date of issuance and (ii) arises out of, or the proceeds of the paper are used for, current transactions.[440]

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439. State blue sky law exemptions usually exist in the form of "securities" exemptions and "transactional" exemptions. "Securities" exemptions exempt securities themselves, rather than particular offers or sales of securities, and continue to operate so long as the securities satisfy applicable requirements. "Transactional" exemptions exempt only specific offers and sales of securities and do not exempt the securities when they are reoffered or resold unless the reoffer or resale is itself an exempt transaction. Consequently, an exempt security may be sold without registration by an issuer to a purchaser and resold by the purchaser without registration regardless of the circumstances of the resale. A security sold without registration by an issuer to that same purchaser in an exempt transaction may be resold by that purchaser without registration only if that resale enjoys its own transactional exemption.

440. The exceptions include South Dakota and Vermont. *See* S.D. CODIFIED LAWS ANN. § 47-31-75 (1983) (maturity of commercial paper limited to six months); VT. STAT. ANN. tit. 9, § 4203(7) (1971) (maturity of commercial paper limited to six months). Some other jurisdictions whose blue sky laws exempt commercial paper meeting the above-described standards have imposed additional requirements making the applicability of the exemption questionable even if the paper is exempt under Section 3(a)(3) of the Securities Act. *See* MINN. RULES part 2875.0130 (1983), 1A BLUE SKY L. REP. (CCH) ¶ 33,403, at 28,401 (specifying what constitutes a current transaction for purposes of the Minnesota blue sky law commercial paper exemption); Oklahoma Blue Sky Regulation Rule R-401(a)(10), 2 BLUE SKY L. REP. (CCH) ¶ 46,411, at 41,519 (specifying certain net worth and other requirements applicable to the Oklahoma blue sky law commercial paper exemption); Wisconsin *Monthly Bulletin*, March 1970, Wisconsin Office of Commissioner of Securities, 3 BLUE SKY L. REP. (CCH) ¶ 64,807, at 56,605 (indicating that certain securities exempt under Section 3(a)(3) of the Securities Act would not be exempt under the Wisconsin blue sky law commercial paper exemption).

Both requirements (i) and (ii) above appear in substance to be identical to the Nine-Month Requirement and the Current Transactions Requirement established under Section 3(a)(3) of the Securities Act. *See supra* text accompanying notes 40-57. Unfortunately, interpretive authority with respect to these requirements, in contrast to the highly developed body of regulatory law under the Securities Act, is largely non-existent. *But see* MINN. RULES part 2875.0130 (1983) 1A BLUE SKY L. REP. (CCH) ¶ 33,403, at 28,401 (specifying what constitutes a "current transaction" for purposes of the Minnesota blue sky law commercial paper exemption). Consequently, in most jurisdictions, although the SEC's standards may serve as useful guidelines, it is difficult to determine with certainty whether the commercial paper exemption would be applicable to a given transaction, absent direct communication with state securities officials.

Stock Exchange Listed Securities. The blue sky laws of the substantial majority of jurisdictions[441] whose blue sky laws require the registration of securities provide exemptions from registration for securities listed on certain stock exchanges.[442] Thus, a foreign bank or an affiliate of a foreign bank that has securities listed on an exchange recognized by a jurisdiction's blue sky laws need not register the securities under the jurisdiction's blue sky law. In addition, many blue sky laws exempt from registration any security that is of senior or substantially equal rank to a security of the same issuer listed on a recognized exchange.[443] This provision may also be of use to a foreign bank or foreign bank affiliate which has outstanding securities in the United States.

Institutional Investor Exemption. Each jurisdiction whose blue sky laws require the registration of securities provides an exemption for offers and sales of securities made to institutional investors. While there is some variation in what constitutes an institutional investor under the blue sky laws of different jurisdictions, offers and sales to certain types of institutions—specifically, banks, savings institutions, and insurance companies—are exempt from registration in practically every jurisdiction. In addition, many jurisdictions provide a version of the Uniform Securities Act institutional investor exemption, which covers—besides banks, savings institutions, and insurance companies—investment companies and pension or profit-sharing plans or trusts, as well as undefined "institutional investors."[444] Finally, many jurisdictions whose institutional investor exemption differs from the Uniform Securities Act version also offer an exemption for offers and sales to undefined "institutional investors."[445]

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441. The exceptions are Kansas, Nevada, New Mexico, North Dakota, and Washington.

442. Securities of issuers which are listed on the New York Stock Exchange or the American Stock Exchange are exempt from registration in each jurisdiction which has an exemption for exchange-listed securities.

443. *See, e.g.*, DEL. CODE ANN. tit. 6, § 7309(a)(8) (1974).

444. These jurisdictions include Alabama, Alaska, Arkansas, Colorado, Delaware, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, Oklahoma, Oregon, South Carolina, Utah, Vermont, Washington, West Virginia, and Wyoming.

445. A foreign bank or an affiliate of a foreign bank issuing securities may consequently qualify for an exemption from securities registration in a jurisdiction by confining offers and sales of the securities in the jurisdiction to the entities specified as institutional investors under the jurisdiction's blue sky laws. The principal difficulty in this area involves determining if an entity not specifically listed in a jurisdiction's list of institutional investors nevertheless constitutes an "institutional investor" as that phrase is used in the jurisdiction's exemptive provision. Because the term "institutional investor" is not defined in most blue sky laws, the SEC's standards in this area may serve as useful guidelines. *See* 17 C.F.R. § 230.501(a) (1985).

Private Placement Exemptions. The blue sky law problems that confront a foreign bank, as well as any other issuer, attempting to make a private placement of securities, are largely technical difficulties. Although a type of private placement or "limited offering" exemption is available in each state which requires the registration of securities, variations in the substantive and procedural requirements of the exemptions present considerable practical difficulties to an issuer attempting to avail itself of this form of exemption.[446] As a result, an issuer of privately-placed securities must be careful to ensure that it satisfies differing jurisdictional standards regarding, among other things, the aggregate amount of securities being placed, the number of offerees or purchasers, the wealth and sophistication of the purchasers, restrictions on resale of the securities, and limitations on the commissions or renumeration paid to persons soliciting investments in the securities.[447]

Although the private placement exemptions do not distinguish between foreign banks and other issuers, several aspects of private placement exemptions under state blue sky laws are of particular interest to a foreign bank issuing securities in the United States pursuant to this method. First, unlike certain other provisions of the blue sky laws, such as the commercial paper exemptions, compliance with the provisions of federal law, i.e., the SEC's Regulation D[448] will not ensure compliance with state private placement exemptions in a significant number of jurisdictions.[449] Second, several aspects of state blue sky law private placement exemptions raise issues that may have a different impact on foreign issuers than on United States issuers.[450] Third, a substantial number of jurisdictions condition the

446. *See generally* 3C BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 14.04A (1984).

447. *Id.*

448. *See supra* text accompanying notes 102-33.

449. For example, although a private placement made pursuant to Rule 506 of Regulation D may be made without registration in all jurisdictions, a considerable number of the jurisdictions either: (i) require the Filing of a Form D (*see, e.g.*, 808 KY. ADMIN. REGS. 10:150 § 2(1)(c) (1982), 1A BLUE SKY L. REP. (CCH) ¶ 27,415, at 22,410, 22,412), (ii) provide grounds for disqualification from the exemption independent of the grounds for disqualification of Rule 506 (*see, e.g.*, Idaho Dep't of Finance, Rule 27 (1982), 1A BLUE SKY L. REP. (CCH) ¶ 21,426, at 17,416), or (iii) impose requirements not in effect under Rule 506 (*see, e.g.*, MD. ADMIN. CODE tit. 02, Rule .09 (1978), 1A BLUE SKY L. REP. (CCH) ¶ 30,435, at 25,420). Consequently, a considerable amount of coordination on the state level is required in order for an issuer, such as a foreign bank, to effect a private placement in certain jurisdictions.

450. For example, most jurisdictions have so-called "bad boy" provisions in their private placement exemptions pursuant to which a judgment entered by a court or other authority with respect to, or the conviction for a crime relating to, the purchase or sale of securities during a specified period of time prior to the private placement will disqualify an issuer from

availability of the exemption on the payment of commissions to registered broker-dealers only.[451]

Another area in which some uncertainty exists concerns numerical limitations under certain private placement exemptions on the number of investors to whom securities may be offered and sold. Under Regulation D, a private placement may be effected in the United States without integrating simultaneous offerings of the same securities outside the United States.[452] Under the numerical limitations on offers and sales established under several states' private placement exemptions, offers and sales made both within and without the jurisdiction are to be counted.[453] Unlike Regulation D, however, the private placement exemptions under state blue sky laws generally do not indicate whether offers or sales to investors outside the United States are to be included. Consequently, a foreign bank effecting a private placement under a jurisdiction's blue sky law may face uncertainty as to whether contemporaneous offers and sales of the same securities outside the United States are to be included in determining compliance with the exemption.

B. *Broker-Dealer Registration*

Every state in the United States requires some form of broker-dealer registration. Broker-dealer registration usually entails a fairly extensive filing requirement, as well as the imposition of a bond and net capital requirements. While most jurisdictions exclude an issuer of securities from the definition of a broker-dealer or its equivalent, several jurisdictions consider issuers selling their own securities to be broker-dealers under certain circumstances.[454] Consequently, a foreign bank offering its securities in any of these jurisdictions must either sell the securities through a registered broker-dealer or register as a broker-dealer in that jurisdiction.

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availing itself of the exemption. *See, e.g.*, IND. ADMIN. R. § 710, 1-3.5-3(3), 1A BLUE SKY L. REP. (CCH) ¶ 24,479, at 19,417-A. Although application of the "bad boy" provision clearly would be triggered by a stop order or conviction in a state, it is unclear whether it would apply to a violation of a foreign country's securities law that is not the subject of judicial or administrative action in the United States or to the commission of an act which, though legal in a foreign country, would be the subject of such an action in the United States.

451. *See, e.g.*, NEB. REV. STAT.] 8-1]111(9) (1983).

452. 17 C.F.R. § 230.502(a) (1985). *See supra* notes 115-19 and accompanying text.

453. *See, e.g.*, CAL. CORP. CODE § 25102(f)(1) (West Supp. 1984) (no more than 35 purchasers within or outside California).

454. *See, e.g.*, VT. STAT. ANN. tit. 9, § 4202(3) (1971).

C. *Advertising Limitations*

A foreign bank issuing securities in various jurisdictions will be subject to certain limitations on advertising contained in the blue sky laws. State blue sky law advertising limitations which exist in most jurisdictions generally deal with at least the following concerns.

First, false or misleading advertising in connection with the offer or sale of either registered or unregistered securities is prohibited.[455] Second, advertising literature used in connection with securities, or transactions in securities, which are not exempt from registration, is required to be filed with the jurisdiction's securities commission.[456] Third, restrictions limit the form and content of advertising permitted under the blue sky laws in connection with both registered and unregistered offerings of securities.[457]

V. FEDERAL INCOME TAX ISSUES

Foreign bank issuances of securities in the United States (whether directly or through a wholly-owned, United States or foreign subsidiary) raise numerous issues involving the United States federal income tax consequences to the issuing corporation and to the United States and foreign holders of the securities. In addition, the application of foreign tax laws to such securities issuances must also be considered. The United States federal income tax consequences of securities issuances in the United States by or for the benefit of foreign banks depend largely upon the structure and type of the issuance. Accordingly, there are separate discussions below of the tax issues associated with debt and equity securities issued directly by a foreign bank (including issuances by a United States branch or agency of the bank) and debt and equity securities issued through a wholly-owned United States subsidiary of the foreign bank.[458] For United States federal income tax purposes, a branch or agency of a foreign

455. *See, e.g.*, KAN. ADMIN. REGS. § 81-10-1(B), 1A BLUE SKY L. REP. (CCH) ¶ 26,410, at 21,423 (1978).

456. *See, e.g.*, MASS. GEN. LAWS ANN., ch. 110A, § 403 (Michie/Law. Coop. 1984).

457. *See, e.g.*, N.C. ADMIN. CODE tit. 18, ch. 6, R. 1308 (1984).

458. In general, this Section does not discuss the provisions of certain tax reform proposals currently being considered by Congress, including the Tax Reform Bill of 1985, H.R. 3838, which was passed by the House of Representatives on December 17, 1985 ("House Bill"). However, mention of certain provisions in H.R. 3838 is made herein where appropriate. This section also does not discuss separately the United States federal income tax consequences of securities issuances in the United States by a foreign subsidiary of a foreign bank since these consequences generally are the same as those applicable to a securities issuance directly by the foreign bank.

bank is not considered a separate entity from the foreign bank itself.[459] Thus, securities issued by any such branch or agency are treated for United States tax purposes as though they were issued directly by the foreign bank.

A. *Securities Issued by a Foreign Bank or its Branch or Agency*

1. *General Rules*

The United States federal income tax consequences resulting to a foreign bank from its direct issuance of debt or equity securities in the United States depend on whether the foreign bank is "engaged in a trade or business within the United States" for federal income tax purposes (Engaged in a United States Business).[460] A foreign bank which is Engaged in a United States Business will be subject to United States federal income tax (at the regular graduated tax rates generally applicable to domestic corporations)[461] on its taxable income which is "effectively connected with the conduct of its trade or business within the United States" (Effectively Connected Income).[462] In determining the amount of such a foreign bank's Effectively Connected Income, deductions are generally allowed only if

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459. However, Section 651 of the House Bill would impose a "branch level tax" on the United States branches of foreign corporations, including foreign banks. In connection with this branch level tax, the House Bill would eliminate the United States withholding tax on interest and dividends paid by a foreign corporation more than 50% of whose aggregate gross income for a specified period is effectively connected with a United States trade or business in which it is engaged. *See infra* text accompanying note 492.

460. For a discussion of the rules for determining when a foreign bank is Engaged in a United States Business, see *infra* text accompanying notes 466-70.

461. Except for corporations with annual taxable incomes in excess of $1,000,000, for taxable years beginning after 1981 domestic corporations are subject to federal income taxation at rates generally ranging from 16% on the corporation's first $25,000 of taxable income to 46 percent on all of the corporation's taxable income in excess of $100,000. *See* I.R.C. § 11 (1982).

462. *Id.* § 882. The general rules for determining when a particular item of income is included in the Effectively Connected Income of a foreign corporation are set forth in *id.* § 864(b), (c) and the Treasury Regulations thereunder. Special rules applicable in this regard to foreign banks are set forth in Treas. Reg. § 1.864-4(c)(5), T.D. 7958, 1984-28, I.R.B. 9-10.

In addition to being subject to United States federal income tax on its Effectively Connected Income, a foreign bank Engaged in a United States Business may be subject to a 30 percent United States withholding tax (or such lower tax as may be provided by a bilateral tax treaty to which the United States is a party) on the *gross* amount (without offset for any deductions) of certain United States source dividends, interest and "other fixed or determinable annual or periodical gains, profits and income" which do not constitute Effectively Connected Income to the bank. I.R.C. § 881(a). The recent repeal of United States withholding tax on certain United States source interest income received by foreign persons does not apply to interest income derived by a foreign bank from commercial loans entered into in the ordinary course of the bank's business. *See id.* § 881(c)(3)(A). *See also supra* note 460 regarding the proposed

and to the extent they are properly allocable to the bank's United States trade or business.[463]

A foreign bank which is not considered Engaged in a United States Business is subject to United States federal income tax only on the gross amount of certain dividends, interest, and other fixed or determinable annual or periodical income, gains, or profits which the bank is treated as deriving from sources within the United States (United States Source Income).[464] The gross amount of such income is subject to a 30 percent United States withholding tax (or such lower tax as may be provided by a bilateral tax treaty to which the United States is a party) without allowance for any deductions.[465]

2. *Engaged in a United States Business*

The determination of whether a foreign bank is Engaged in a United States Business is made on the basis of the particular facts and circumstances relating to the quantity and nature of the bank's activities in the United States.[466] As noted above, under current law

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imposition by the House Bill of a new "branch level tax" on the United States branches of foreign corporations.

463. I.R.C. § 882(c)(1)(A). Treasury Regulations issued under I.R.C. § 882(c) provide detailed rules for determining when a particular item of expense is properly allocable to Effectively Connected Income so as to be deductible by a foreign corporation for United States federal income tax purposes. See Treas. Reg. § 1.882-5a and *infra* text accompanying notes 471-73 regarding the special rules provided for determining the extent to which interest expense incurred by a foreign bank is properly allocable to Effectively Connected Income. A foreign bank will be entitled to claim federal income tax deductions for an expense properly allocable to the bank's Effectively Connected Income only if the bank files a federal income tax return for the taxable year in question. *Id.* § 882(c)(2).

464. *Id.* § 881(a). As indicated in *supra* note 488, the recent repeal of United States withholding taxes on certain interest income constituting United States Source Income does not apply to interest income derived by a foreign bank from commercial loans entered into in the ordinary course of the bank's business. *See Id.* § 881(c)(3)(A). Specific rules for the determination of the source of particular items of income are set forth in I.R.C. §§ 861, 862, and the Treasury Regulations thereunder.

465. I.R.C. §§ 881(a), 894(a).

466. *See* Spermacet Whaling & Shipping Co. v. Commissioner, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960); *see also* Higgins v. Commissioner, 312 U.S. 212 (1941) (determination of whether taxpayer is "carrying on business" requires an examination of the facts and circumstances in each case).

Neither the I.R.C. nor the Treasury Regulations offer a comprehensive definition of the term "engaged in a trade or business within the United States." While I.R.C. § 864(b) and the Treasury Regulations thereunder provide detailed rules for determining whether nonresident alien individuals and foreign corporations are Engaged in a United States Business, these rules apply to only two situations: 1) the performance of personal services; and 2) the trading of securities or commodities. *See* Treas. Reg. § 1.864-2(e), T.D. 7378 (1975).

Applicable case law indicates that the determination of a foreign corporation's "trade or business" status depends generally on two factors, "continuity of activity" and "active pursuit

a branch or agency of a foreign bank is not considered a separate entity apart from the foreign bank for United States federal income tax purposes.[467] Thus, any activities conducted by such branch or agency are considered to be carried on by the foreign bank in determining whether the foreign bank is considered Engaged in a United States Business for United States tax purposes. A foreign bank which actively conducts banking operations in the United States, whether directly or through a branch or agency, clearly is Engaged in a United States Business.

However, a foreign bank may engage in some activities in the United States which do not rise to the level of a trade or business in the United States. For example, a foreign bank which merely invests or trades in debt or equity securities in the United States for its own account generally is not considered to be Engaged in a United States Business, regardless of the volume of the bank's United States in-

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of profit." S. Roberts & W. Warren, *U.S. Income Taxation of Foreign Corporations and Nonresident Aliens*, ¶ V/2 (1967). The seminal case in this area, Lewellyn v. Pittsburgh, B. & L.E.R. Co., 222 F. 177 (3d Cir. 1915), states that "engaged in business . . . convey[s] the idea of progression, continuity or sustained activity." 222 F. at 183. *See, e.g.*, Wier v. Enochs, 64-1 U.S.T.C. (CCH) ¶ 9387, at 92,009 (S.D. Miss. 1963), *aff'd per curiam*, 353 F.2d 211 (5th Cir. 1965); Spermacet Whaling and Shipping Co. v. Commissioner, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960). It follows that engaging in a few small isolated activities or transactions in the United States generally will not cause a foreign corporation to be considered as Engaged in a United States Business. *See* Continental Trading, Inc. v. Commissioner, 265 F.2d 40, 44-45 (9th Cir.), *cert. denied*, 361 U.S. 827 (1959) (isolated and noncontinuous transactions by foreign corporations in the United States resulting in "nominal amounts of income" did not cause these corporations to be Engaged in a United States Business); Linen Thread Co. v. Commissioner, 14 T.C. 725 (1950) (two sales by a foreign corporation totalling approximately $800 did not cause this corporation to be Engaged in a United States Business).

Active pursuit of profit is the second factor to be considered in determining whether nonresident alien individuals or foreign corporations are Engaged in a United States Business. This factor distinguishes mere passive investment from active participation in a business. *See* Di-Portanova v. United States, 690 F.2d 169, 174 (Ct. Cl. 1982) ("To be Engaged in . . . business requires active involvement, personally or through an agent, in the operation of that business.") Weir v. Enochs, 64-1 T.C.M. ¶ 9387, at 92,007 (S.D. Miss. 1963), *aff'd per curiam*, 353 F.2d 211 (5th Cir. 1965) (amount of time and energy devoted to business and extent of attention to daily details of management of business are factors to be considered in determining whether party is engaged in business).

Scottish American Investment Co. v. Commissioner, 12 T.C. 49 (1949), involved a foreign investment corporation with a United States office. All investment and management decisions were made by the home offices in Scotland, and all security transactions were executed by the home office directly through resident brokers. Since the United States office merely maintained records and performed routine clerical functions, the investment corporation was not considered to be Engaged in a United States Business.

The following discussion in the text assumes that the management and policy decisions affecting the foreign bank are not made in the United States.

467. *See supra* note 460 regarding the proposed imposition of a new branch level tax on United States branches of foreign corporations.

vestment or trading activity.[468] Furthermore, a foreign bank which has only a minimal presence in the United States, such as a representative office whose activities consist merely of data gathering and the establishment of business contacts for the bank's home office, also is generally not considered to be Engaged in a United States Business.[469] While there is no authority directly on point, a foreign bank which is not otherwise Engaged in a United States Business should generally not be considered so engaged merely because it issues its debt or equity securities in the United States.[470]

3. *Debt Securities*

a. *Tax Consequences to the Foreign Bank*

i. *Deductibility of Interest Expense If Engaged in a United States Business*

As noted above, in computing the amount of its taxable income which is annually subject to United States federal income taxation, a foreign bank Engaged in a United States Business is entitled to deduct items of expense deductible by United States corporations, such as interest, to the extent such items are properly allocable to the bank's United States trade or business.[471] Specific rules for determining the deductibility of interest expense incurred by a foreign

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468. I.R.C. § 864(b) (1982) and Treas. Reg. § 1.864-2(b) (1968) provide specific statutory exemptions from "trade or business" status for these activities. A foreign corporation generally will qualify for these exemptions provided its "principal office" is outside of the United States.

469. *See* Rev. Rul. 72-418, 1972-2 C.B. 661. *See also* Hatab, *U.S. Taxation of Foreign Banking in the United States-An Overview*, 41st ANN. N.Y.U. INSTIT. ON FEDERAL TAXATION ¶ 27.01[1][a]. See, however, Private Letter Ruling 8010040 (Dec. 11, 1979) which indicates in analyzing a different tax issue that the liaison-related activities normally engaged in by a bank's representative office possibly might be considered by the Internal Revenue Service to rise to the level of a "trade or business" for federal income tax purposes.

470. Continuous activity by a foreign corporation in negotiating and renegotiating loans in the United States with United States banks has been considered to be insufficient to cause the foreign corporation to be treated as Engaged in a United States Business. Continental Trading, Inc. v. Commissioner, 265 F.2d 40 (9th Cir. 1959), *cert. denied*, 361 U.S. 827 (1959). Further, Rev. Rul. 55-182, 1955-1 C.B. 77 holds that a Canadian mutual fund which maintained no office in the United States, which was subject to the Investment Company Act, and which sold most of its shares to United States citizens and residents in offerings registered with the SEC was not Engaged in a United States Business where all its major policy decisions were made outside the United States. However, it is noted that in Rev. Rul. 73-227, 1973-1 C.B. 338, the Internal Revenue Service held that a foreign corporation which engaged solely in the business of borrowing funds and relending them to its domestic parent and to other domestic and foreign affiliates was Engaged in a United States Business where its principal office was maintained in the United States and substantially all of its business activities took place in this country.

471. I.R.C. § 882(c)(1)(A) (1982). *See supra* text accompanying notes 462-63.

bank are provided in Treasury Regulations issued under Section 882 of the Internal Revenue Code of 1954, as amended (Code).[472]

Under these Regulations, the portion of the foreign bank's aggregate worldwide interest expense which is considered allocable to its United States trade or business is determined by a complex three step formula.[473] The portion of the bank's worldwide interest expense deemed allocable to its United States trade or business under this formula is deductible by the bank in computing its United States taxable income, regardless of whether the bank actually uses the related loan proceeds in connection with such trade or business. Accordingly, at least some portion of the interest expense on debt securities issued by a foreign bank Engaged in a United States Business should be deductible by the foreign bank in computing its United States taxable income.

ii. *Deductibility of Interest Expense If Not Engaged in a United States Business*

As noted above, a foreign bank not Engaged in a United States Business for federal income tax purposes is subject to United States tax (collectible by withholding at source by the payor) at a flat 30 percent rate (or such lower rate as may be provided by a bilateral tax treaty to which the United States is a party) on the gross amount of certain types of United States Source Income, without any deduction for related expenses.[474] Therefore, any interest expense incurred by such foreign bank in connection with its issuance of debt securities in the United States will not be deductible by the bank for United States tax purposes. However, such interest expense

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472. Treas. Reg. § 1.882-5, T.D. 7939, 1984-12 I.R.B. 6 [hereinafter cited as Treas. Reg. § 1.882-5].

473. Treas. Reg. § 1.882-5 provides the following three step formula for determining the allowable interest deduction of a foreign bank Engaged in a United States Business:

(1) The average value (using either fair market value or book value) of the bank's assets which are effectively connected with its United States business is determined;

(2) The amount of the bank's liabilities deemed allocable to such assets is determined by multiplying the value determined in step (1) by either:
(i) the bank's actual worldwide ratio of liabilities to assets or
(ii) a fixed ratio of 95 percent; and

(3) Interest attributable to the liabilities determined in step (2) is computed by reference to either (i) overall average interest rates or (ii) average interest rates on each separate currency borrowed by the foreign bank. This amount is deemed to be the interest expense allocable to the foreign bank's United States trade or business and is deductible by the bank in computing its United States taxable income.

Id.

474. I.R.C. § 881(a) (1982). *See supra* text accompanying notes 464-65.

may be deductible by the foreign bank in determining its tax liability in the foreign country or countries in which it is incorporated or resident.[475]

iii. *Registered Securities*

In general, a foreign bank Engaged in a United States Business must issue its publicly offered debt securities in the United States which have a maturity of more than one year "in registered form" in order to be entitled to a federal income tax deduction for the interest paid or accrued on the securities.[476] A debt security will be considered to be issued "in registered form" for this purpose if either (i) the security is registered as to both principal and any stated interest and the transfer of the security may be effected only by the surrender of the instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, or (ii) the right to the principal of, and stated interest on, the security may be transferred only through a "book entry" system.[477]

Commercial paper issued by a foreign bank would generally be exempt from these registration requirements since the term of such obligations is less than one year.[478] Accordingly, such commercial paper can be issued by a foreign bank in bearer form in the United States. However, medium- and long-term debt obligations issued by a foreign bank in the United States would be subject to the registration requirements and accompanying sanctions contained in the Code.

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475. Most foreign countries (*e.g.*, Canada and the United Kingdom) permit corporate taxpayers, including banks, to deduct their interest expenses in computing their foreign tax liability.

476. I.R.C. § 163 (f)(2)(A)(iii) (1982). This prohibition applies equally to domestic issuers of debt securities. In addition to the denial of an interest deduction to an issuer which does not comply with these debt registration requirements, other sanctions imposed under the Code apply to the issuer and holders of registration-required obligations which are not issued "in registered form." These sanctions include an excise tax imposed on the issuer equal to one percent of the principal amount of the obligation multiplied by the number of years in the term of the obligation and the denial of capital gain treatment or a loss deduction, as the case may be, to a holder of the obligations upon their disposition by sale, exchange, redemption or worthlessness. *Id.* §§ 165(j), 1287, and 4701.

477. *Id.* §§ 163(f)(3), 103(j)(3). Under Temporary Treas. Reg. § 5f.103-1(c)(2) (1985), an obligation shall be considered transferable through a "book entry system" if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A "book entry" is a record of ownership that identifies the beneficial owner of an interest in the obligation.

478. I.R.C. § 163(f)(2)(A)(iii).

iv. *Foreign Withholding Taxes*

Interest paid by foreign banks to individual citizens or residents of the United States and to United States corporations, partnerships, trusts, and estates (United States Persons)[479] on debt securities issued in the United States may be subject to withholding taxes in the foreign jurisdiction(s) in which the foreign bank is incorporated or resident. While many foreign countries impose withholding taxes on interest paid by a resident of that country to nonresidents thereof,[480] other foreign countries either do not impose any withholding tax on interest paid to nonresidents[481] or exempt from their taxation interest on certain types of debt obligations issued by foreign banks.[482] Further, certain foreign countries are parties to tax treaties with the United States whereby interest paid by residents of those foreign countries to United States Persons is either exempt from foreign withholding tax or subject to a reduced rate of foreign withholding tax.[483] Accordingly, in connection with the direct issuance of debt securities by a foreign bank in the United States, the internal tax law of the foreign country in which the issuing bank is resident or incorporated and any tax treaty between that country and the United States should be examined to determine whether there are any foreign withholding taxes applicable to the interest paid to United States Persons holding the bank's debt securities.[484]

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479. An estate or trust constitutes a United States Person if it would be subject to United States federal income taxation without regard to the source of its income. *See id.* § 7701(a)(30) and (31).

480. For example, subject to certain statutory exceptions, Canada and Belgium each impose withholding taxes on interest paid by a resident of those countries to nonresidents thereof.

481. Germany and Austria are two examples.

482. For example, Canadian tax law specifically exempts from Canadian withholding tax interest paid in a foreign currency by certain Canadian banks to nonresidents of Canada.

483. *See, e.g.*, Article 11 of the United States—United Kingdom Income Tax Convention, which exempts from United Kingdom withholding tax interest paid by United Kingdom persons to United States residents.

484. To avoid the imposition of foreign withholding taxes on interest paid to United States residents, foreign banks sometimes obtain funds in the United States indirectly through their borrowing of the net proceeds of debt securities issued by their United States subsidiaries or by their subsidiaries incorporated in another foreign country which has a tax treaty with the United States exempting interest paid to United States residents from foreign withholding taxes. *See infra* note 513.

v. *Information Reporting and Backup Withholding*

Payments of interest to a United States Person other than certain statutorily exempt recipients (Exempt Recipients)[485] generally are subject to certain procedures designed to ensure that the beneficial owner of the interest reports this income on its United States federal income tax return. Subject to certain statutory exceptions, any person who pays interest to any United States Person other than an Exempt Recipient during a particular year is required to file an annual information return with the Internal Revenue Service with respect to that payment.[486] Payments of interest by a foreign bank to a United States Person within the United States (whether by a United States branch or agency of the foreign bank or an unrelated paying agent) would be subject to information reporting by the payor.[487] Information reporting generally does not apply to interest paid by a foreign bank to a nonresident alien or foreign corporation.[488]

To further ensure that the beneficial owner of interest income reports this income, a "backup withholding" system generally applies to payments of interest which are subject to information reporting by the payor. Under this system, a payor of interest generally is re-

485. The following persons or entities, among others, constitute Exempt Recipients for this purpose: (1) corporations; (2) noncorporate entities which are exempt from federal income taxation under I.R.C. § 501(a) (1982) (*e.g.*, charitable organizations, qualified pension, profit sharing and other retirement trusts) or individual retirement accounts; (3) securities and commodities dealers required to register as such under the laws of the United States or a State; (4) real estate investment trusts; (5) entities registered at all times during the year under the Investment Company Act (i.e., mutual funds); (6) certain governmental entities and trust funds; (7) a nominee or custodian, except as otherwise provided in regulations to be issued by the Treasury Department; and (8) any person or entity (including a financial institution or broker) who collects any interest for the payee or otherwise acts as a "middleman" between the payor and payee, but only to the extent to be provided in Treasury Department regulations. *See* I.R.C. § 6049(b)(4) (1982).

486. I.R.C. § 6049 requires such information reporting with respect to any payment of at least $10 of interest to any person during the year. The person required to file these information reports is the actual payor of the interest to the United States Person who is a beneficial owner of the interest. Thus, payments of interest to a nominee, a custodian or similar "middleman" of the beneficial owner are exempt from information reporting, but such reporting must be made by the nominee, or custodian or middleman, as the case may be. *See id.* § 6049(a)(1).

487. *See id.* § 6049(b)(2)(D)-(3). However, payments of interest outside the United States to a United States Person other than an Exempt Recipient are exempt from any information reporting so long as interest paid by the foreign bank to a nonresident alien or a foreign corporation would be exempt from United States withholding tax. *Id.* § 6049(b)(2)(D) and Treas. Reg. § 1.6049-5(b)(1)-(3).

488. *See id.* § 6049(b)(2)(C)(ii)-(5)(B)(i) and Treas. Reg. §§ 1.6049-5(b)(vi)(B)(1), 1.6049-5(b)(2)(iv) (1984). Unless it has actual knowledge that the payee of an amount is a United States Person, a payor may avoid such information withholding if it receives a certification from the payee (signed under penalty of perjury) that the payee is not a United States Person.

quired to deduct and withhold income tax from this interest at a rate of twenty percent if the payee does not provide the payor with correct information regarding the payee's taxpayer identification number.[489] Interest paid by a foreign bank to a United States Person or a nonresident alien individual or foreign corporation on its debt securities would potentially be subject to backup withholding to the same extent they are subject to information reporting.[490]

b. *Tax Consequences to the Holders*

A United States Person holding a debt security issued by a foreign bank will be required to include the full amount of any interest paid or discount on such debt securities in his taxable income for federal income tax purposes.[491] A nonresident alien individual or a foreign corporation not Engaged in a United States Business that holds debt securities issued directly by a foreign bank generally will be subject to United States federal income tax with respect to interest paid on such securities only if more than fifty percent of the bank's aggregate gross income for a specified base period (generally the three-year period preceding the foreign bank's payment of the interest in question) is included in the bank's Effectively Connected Income.[492]

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489. *See id.* § 3406 and Treasury Regulations thereunder. Specifically, backup withholding would apply where (1) the payee fails to furnish his taxpayer identification number to the payor in the manner required, (2) the Internal Revenue Service notifies the payor that the taxpayer identification number furnished by the payee is incorrect, (3) the Internal Revenue Service notifies the payor that backup withholding should commence became the payee has failed to properly report his receipt of interest, or (4) when required to do so, the payee fails to certify, under penalties of perjury, that he is not subject to backup withholding by reason of a specific statutory exemption.

490. *See id.* § 3406(a)(1), (b)(1), (b)(2)(A)(i).

491. *Id.* § 61(a)(4). Interest income will be includible in the gross income of a United States Person in accordance with the method of accounting utilized by the United States Person for federal income tax purposes. However, both cash and accrual basis United States Persons would include in their gross income "original issue discount" on debt securities over the term of the securities. *See* § 1272. Subject to certain limited exceptions, "original issue discount" means the difference between the original issue price of a debt obligation and the stated amount payable to the holder of the obligation at maturity (including any deferred interest payable at that time). *Id.* § 1273(a)-(c).

492. Nonresident alien individuals and foreign corporations not Engaged in a United States Business are subject to United States federal income tax only on certain types of United States Source Income. *See id.* §§ 871, 881. Under I.R.C. § 861(a)(1)(A) and (C), and I.R.C. § 862 (1982), interest paid by a foreign bank which does not satisfy this 50% gross income test to any such nonresident alien or foreign corporation would be considered non-United States Source Income and, accordingly, would not be subject to United States withholding tax. As noted in *supra* note 460, the House Bill would eliminate this 50% gross income test in determining whether such interest is United States Source Income subject to United States withholding tax. The same rules discussed in the text with respect to nonresident alien individuals

However, even if a foreign bank satisfies this fifty percent gross income test, interest paid to a nonresident alien or foreign corporation on "deposits" issued by the foreign bank would be exempt from United States federal income taxation provided the interest does not constitute Effectively Connected Income to the recipient.[493] A nonresident alien or foreign corporation Engaged in a United States Business and holding the debt securities of a foreign bank in connection with this business may be subject to United States federal income taxation with respect to the interest payable on such securities regardless of whether the foreign bank satisfies this fifty percent gross income test.[494]

If a foreign withholding tax is imposed on interest income paid by a foreign bank to a United States Person, the United States Person may elect either to deduct the amount of such foreign tax in computing its United States taxable income or claim a foreign tax credit against its United States federal income tax liability for the amount of such tax, subject to certain annual limitations.[495] In general, the foreign tax credit would be more advantageous to a United States

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and foreign corporations generally also apply to foreign partnerships, trusts and estates. However, a nonresident alien individual or foreign corporation, trust or estate will be treated as Engaged in a United States Business if it is a partner (whether a general partner or a limited partner) in a partnership (regardless of whether it is formed in the United States) Engaged in a United States Business. *See id.* § 875; Donroy, Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962).

493. I.R.C. §§ 861(a)(1)(A) and 861(c). Time certificates of deposit, open account time deposits and multiple maturity time deposits have all been held by the Internal Revenue Service to constitute "deposits" within the meaning of these statutory provisions. *See* Rev. Rul. 72-104, 1972-1 C.B. 209. *See also* Rev. Rul. 70-436, 1970-2 C.B. 148; Rev. Rul. 73-505, 1973-2 C.B. 224 and Rev. Rul. 75-449, 1975-2 C.B. 285.

494. Even if the interest paid by a foreign bank does not constitute United States Source Income, this interest may constitute Effectively Connected Income to the recipient nonresident alien individual or foreign corporation if (1) the foreign recipient has an "office or other fixed place of business" within the United States and the interest is "attributable to" this office, and (2) the foreign recipient is engaged in the conduct of a "banking, financing or similar business within the United States" or is engaged in trading in stocks or securities for its own account as its principal business. I.R.C. § 864(c)(4), (5) (1982). Whether a nonresident alien individual or foreign corporation has an "office or fixed place of business" within the United States is determined under rules prescribed in Treas. Reg. § 1.864-7 (1972). The rules for determining whether interest income is "attributable to" such an "office or fixed place of business" is determined under rules contained in I.R.C. § 864(c)(5) (1982) and Treas. Reg. § 1.864-6 (1972). Interest derived by a foreign corporation engaged in a "banking, financing or similar business" (as such term is defined in *id.* § 1.864-4(c)(5)), will generally satisfy the "attributable to" test only if a United States office of the corporation actively and materially participated in soliciting, negotiating or performing other activities required to arrange the acquisition of the underlying debt obligation (whether or not the United States office was not the only active participant in arranging this acquisition). *Id.* §§ 1.864-6(b); 1.864-4(c)(5)(ii).

495. I.R.C. §§ 164, 901, 904 (1982).

Person than a deduction since the credit reduces United States federal income tax liability on a dollar for dollar basis. However, as noted above, the amount of foreign tax credit which may be taken is subject to certain annual limitations, the most significant of which is that the total amount of the credit cannot exceed the taxpayer's total United States federal income tax liability multiplied by the ratio of the taxpayer's foreign source taxable income to total worldwide taxable income.[496] Thus, where foreign tax rates exceed the United States tax rates to which the United States Person may be subject, the foreign tax credit may be limited to only a portion of the foreign taxes imposed on the interest paid by a foreign bank to the United States Person. Any otherwise allowable foreign tax credits which cannot be utilized in a particular year by reason of an annual limitation may be carried back and/or carried forward to other years by a United States Person to reduce its United States tax liability in these other years.[497]

Subject to certain special rules, a nonresident alien individual or foreign corporation Engaged in a United States Business is also entitled to a credit against the United States federal income tax otherwise imposable on its Effectively Connected Income for any foreign withholding taxes imposed on interest income which it receives from a foreign bank and which constitutes Effectively Connected Income.[498] The annual limitations on the amount of foreign tax credit able to be claimed by a United States Person also apply to such a nonresident alien individual or foreign corporation.

4. *Equity Securities*

a. *Tax Consequences to the Foreign Bank*

Dividends paid by a corporation on its equity securities are not currently deductible by the corporation for United States federal in-

496. *Id.* § 904. In the case of most types of interest income received by a United States Person (which would in most cases include interest income derived from debt securities issued by foreign banks), the foreign tax credit limitation is applied separately to foreign taxes on such interest income. *Id.* § 904(d). The House Bill would amend I.R.C. § 904 to also apply a separate foreign tax credit limitation to certain other types of income. *See* Section 601 of H.R. 3838.

497. I.R.C. § 904(c) (1982) generally provides specific rules whereby any such "excess foreign tax credits" derived by a United States Person can be carried back two years and, to the extent not fully utilized in these prior years, carried forward for five years.

498. *Id.* § 906(a).

come tax purposes.[499] Accordingly, even if a foreign bank is Engaged in a United States Business, any dividends paid by the foreign bank on its equity securities issued in the United States will not be deductible in computing the bank's United States taxable income. Furthermore, such dividends may not be deductible by the bank in the foreign country in which it is incorporated or resident.[500]

Dividends paid by a foreign bank to a United States Person will be subject to applicable information reporting and backup withholding requirements[501] unless the bank is not Engaged in a United States Business and does not have an office, place of business, or fiscal or paying agent in the United States.[502]

Dividends paid by a foreign bank to a nonresident alien individual or foreign corporation generally are not subject to annual information reporting.[503]

The foreign country in which the foreign bank is resident or incorporated may impose withholding taxes on dividends paid to nonresidents of that country.[504] The amount of such withholding tax imposed on dividends paid to United States Persons may be reduced by a tax treaty between the United States and the foreign country imposing the withholding tax.[505]

b. *Tax Consequences to the Holders*

A United States Person receiving dividends on equity securities issued directly by a foreign bank generally is required to include the full amount of such dividends in its taxable income for United States federal income tax purposes.[506] Such dividends will not qualify for

499. Section 311 of the House Bill would amend the Internal Revenue Code to permit payers of dividends generally to deduct currently an amount equal to 10 percent of these dividends.

500. For example, neither Canada nor Belgium allows a corporate taxpayer a deduction for dividends paid.

501. *See supra* text accompanying notes 486-88.

502. Similar to the annual information reporting requirements relating to interest payments, *see* notes 491-95. I.R.C. § 6042 (1982) generally requires any person paying at least $10 of dividends in any one year to any other person to report such payments to the Internal Revenue Service. *See* I.R.C. § 6042(a), (b)(2)(A) (1982) and Treas. Reg. § 1.6042-3(b).

503. *See* I.R.C. § 6042(b)(2)(B) and Treas. Reg. § 1.6042-3(b)(2) (1962).

504. For example, Canada, Belgium, France, and the United Kingdom presently all impose withholding taxes on dividends paid by their residents to nonresidents.

505. Under most tax treaties to which the United States is a party, the foreign withholding rate on dividends paid to a United States Person is reduced to 15 percent or less. *See, e.g.*, United States-Canada Income Tax Convention, Article X.

506. I.R.C. § 61(a)(7) (1982). Dividends will be includible in the gross income of a United States Person in accordance with the method of accounting utilized by the United States Person.

the $100 dividends received exclusion available to individual taxpayers ($200 for taxpayers filing joint returns) since that exclusion only applies with respect to dividends from domestic corporations.[507] Of more importance, such dividends also generally will not qualify for the eighty-five percent dividends received deduction generally available to corporate taxpayers since dividends paid by a foreign corporation will qualify for such deduction only if at least fifty percent of the aggregate worldwide gross income of the foreign corporation for a specified base period (generally the three-year period preceding the foreign corporation's payment of the dividend) is included in the Effectively Connected Income of the foreign corporation.[508]

Foreign withholding taxes imposed on the dividends paid by a foreign bank to a United States Person may be deductible by such person in computing his United States federal taxable income, or in the alternative, creditable against his United States federal income tax liability, subject to certain annual limitations.[509]

A nonresident alien individual or foreign corporation holding equity securities issued directly by a foreign bank generally will be subject to United States federal income tax with respect to dividends paid by the foreign bank only if at least fifty percent of the bank's aggregate worldwide gross income for a specified base period (generally the three-year period preceding the foreign corporation's payment of the dividends) is included in the Effectively Connected Income of the bank.[510] A nonresident alien individual or foreign corporation Engaged in a United States Business and holding the equity securities of a foreign bank in connection with this business may, however, be subject to United States federal income taxation with respect to dividends paid on these securities regardless of whether the foreign bank satisfies this fifty percent gross income test.[511]

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507. *Id.* § 116(a)(1).

508. *Id.* §§ 243(a), 245. Under I.R.C. § 245, the percentage of the dividends paid by such a foreign corporation which will qualify for the 85% dividends received deduction is equal to the percentage of the corporation's aggregate worldwide gross income which is included in its Effectively Connected Income.

509. *See supra* text accompanying notes 495-97. Section 602 of the House Bill would provide a limitation on the extent to which a United States bank would be entitled to a foreign tax credit for certain foreign "gross-basis" taxes on interest received by United States banks and for certain foreign taxes used directly or indirectly as a subsidy to such banks.

510. *See* I.R.C. §§ 861(a)(2)(B), 862(a)(2), 1441, 1442 (1982).

511. The circumstances under which such a nonresident alien individual or foreign corporation may be so subject to United States federal income taxation on dividends paid by a foreign bank are the same as those described *supra* note 494. But *see supra* note 460 regarding the provisions of the House Bill which propose to make certain changes to this taxation.

B. *Securities Issued by a United States Subsidiary of a Foreign Bank*

1. *Introduction*

As discussed above, business and marketing considerations may dictate in certain cases that foreign banks issue debt securities in the United States through a United States finance or other subsidiary of the bank. Many foreign banks have formed subsidiaries in the United States to engage in banking and other activities. Securities issued by United States banking and other operating subsidiaries of a foreign bank generally would be subject to the same United States federal income tax considerations as issuances of securities by any other United States corporation. Except with respect to issuances of adjustable rate preferred stock as discussed below, this article generally does not discuss the United States federal income tax consequences of these securities issuances.[512] Further, a foreign bank incorporated in a country which imposes a withholding tax on interest (or discount) paid to United States Persons holding its debt securities may wish to utilize a finance subsidiary to issue debt securities in the United States for its benefit in order to avoid these foreign withholding taxes.[513]

2. *Debt Securities Issued by United States Finance Subsidiaries*
a. *Finance Subsidiary Structure*

A finance subsidiary of a foreign bank (Finance Subsidiary) generally is incorporated in Delaware with a relatively nominal amount

512. For a discussion of the United States federal income tax issues arising where a United States subsidiary lends the proceeds of its debt securities to its foreign bank parent or affiliates, see *infra* note 521.

513. The avoidance of such foreign withholding tax is often cited as a reason for a foreign bank's formation of a United States finance subsidiary in the applications filed by the banks with the SEC under Section 6(c) of the Investment Company Act. *See, e.g., In re* Banque Indosuez and Indosuez North America, Inc., SEC Investment Co. Act Release No. 13,517 (Sept. 20, 1983), 28 S.E.C. Docket 1128; *In re* Compagnie Financiere de Paribas and Paribas Finance Inc., SEC Investment Co. Act Release No. 12,948, 26 S.E.C. Docket 1664 (Jan. 6, 1983).

To avoid the imposition of any foreign withholding tax on the payment of interest (or discount) to United States Persons holding its securities, foreign banks sometimes issue debt securities in the United States through finance subsidiaries incorporated in another foreign country which either (1) does not impose any withholding tax on payments of interest (or discount) to foreigners, or (2) is a party to a bilateral tax treaty with the United States which exempts from withholding tax imposed by the foreign country payments of interest (or discount) paid by a resident of that foreign country to residents of the United States. *See, e.g., In re* Banque Europeenne de Credit S.A. and BEC Finance N.V., SEC Investment Co. Act Release No. 11,138, 19 S.E.C. Docket 1284 (April 22, 1980).

of equity capital. The Finance Subsidiary's sole activities generally consist of issuing its debt securities ("Securities") in the United States and loaning all of the net proceeds thereof (after application of these proceeds to the extent necessary to redeem previously issued securities which have matured or to pay expenses of the issuance) to its parent foreign bank and/or to one or more of the parent's affiliates (Bank Affiliates).[514] The bank or the Bank Affiliates, or both, generally are made unconditionally obligated to repay their loans to the Finance Subsidiary whenever the Finance Subsidiary is required to repay the Securities which funded the loans. However, the parties may agree to postpone repayment of the principal of these intercompany loans if the Finance Subsidiary issues new Securities sufficient in amount to enable it to repay its matured Securities and treat the Finance Subsidiary as having made a new loan to the bank or Bank Affiliates, as the case may be. The bank and/or the Bank Affiliates generally are also unconditionally obligated to periodically reimburse the Finance Subsidiary for amounts sufficient to enable the Finance Subsidiary to pay all of the discount or interest, as the case may be, on maturing Securities on a timely basis and to pay all of the costs and expenses the Finance Subsidiary incurs in connection with its issuance of the Securities (other than its tax liabilities resulting from such issuance).[515]

As discussed above, the Finance Subsidiary's repayment obligations to the holders of its Securities (the "Securities Holders") are typically supported by the parent foreign bank in one of several alternative forms.[516] For example, the bank may unconditionally guarantee to the Securities Holders the Finance Subsidiary's obligations to repay the Securities on a timely basis.[517] The parent foreign bank generally is not compensated by the Finance Subsidiary for this guarantee. Alternatively, the foreign bank may execute a written keepwell undertaking whereby it agrees to provide the Finance Subsidiary with whatever funds the Finance Subsidiary may need to make timely payment of all of its liabilities, indemnities, and obligations (whether direct or indirect, absolute or contingent, or now or

514. *See, e.g., In re* Societe Generale de Banque S.A. and Societe Generale de Banque Inc., SEC Investment Co. Act Release No. 11,234 (June 27, 1980), 20 S.E.C. Docket 540.

515. The terms of the loans made by a Finance Subsidiary to the foreign bank and/or one or more Bank Affiliates are often contained in one or more written advance agreements.

516. For a more complete discussion of the alternative forms by which the parent foreign bank could provide credit support for the securities, see *supra* note 256 and accompanying text.

517. *See, e.g., In re* Societe Generale de Banque S.A. and Societe Generale de Banque Inc., SEC Investment Co. Act Release No. 11,234 (June 27, 1980), 20 S.E.C. Docket 540.

hereafter existing) to (1) the Securities Holders (including the aggregate amount of interest or discount payable on the Securities), (2) the issuing and paying agent for the Securities, and (3) certain other designated persons (these obligations of the bank are hereinafter collectively referred to as the Bank Undertakings).[518] In this latter situation, the bank would agree that the Securities Holders would be third party beneficiaries of the Bank Undertakings and the bank's unconditional obligation to repay timely its loans from the Finance Subsidiary.

A Finance Subsidiary generally does not have its own employees or office space but uses the employees and office space of its parent bank or a Bank Affiliate (whether in the United States or in the foreign country in which the parent or the Bank Affiliate maintains an office).[519] The Finance Subsidiary generally realizes a reasonable profit each year which would be subject to United States Federal income taxes.[520]

A Finance Subsidiary generally will observe all corporate formalities. Thus, it will hold periodic directors meetings, have an office (which, as noted above, is typically shared with an affiliate), maintain adequate books and records, maintain its own bank account and have officers and directors.

b. *Summary of Relevant Federal Income Tax Issues*

i. *Introduction*

The above-described relationships between a foreign bank, its Bank Affiliates and a Finance Subsidiary raise certain United States federal income tax issues. The resolution of most of these issues depends upon the identity of the obligor of the Securities for federal income tax purposes.

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518. *See, e.g., In re* Bergen Bank Corp., SEC Investment Co. Act Release No. 13,994 (June 5, 1984).

519. The provision of services and facilities to the Finance Subsidiary often is governed by a written agreement entered into between the Finance Subsidiary and its parent or the Bank Affiliate, as the case may be. The Finance Subsidiary typically pays the entity providing it with services and facilities an annual fee (often determined on a cost-plus basis) in consideration therefor. The amount of this annual fee generally is determined so as to satisfy the "arm's length" standard of I.R.C. § 482. *See infra* notes 551-53 and accompanying text.

520. The Finance Subsidiary may derive this annual profit by (i) having its parent bank and/or each Bank Affiliate to whom it loans funds pay the Finance Subsidiary an annual fee in consideration for its commitment to make loans to the payor, or (ii) charging more interest on its loans to its affiliates than the sum of the interest it must pay on the Securities and its operating expenses, or both. The arrangements between the Finance Subsidiary and the affiliates to whom it makes loans are structured so as to satisfy the "arm's length" test of I.R.C. § 482. *See infra* notes 551-53 and accompanying text.

The most important of these issues is whether any adverse United States federal income tax consequences will result to the Finance Subsidiary or the foreign bank by reason of the Finance Subsidiary's nominal equity capital and the foreign bank's direct or indirect credit support of the repayment of the Securities. Assuming the Subsidiary is treated for federal income tax purposes as the obligor of the Securities, issues also arise as to (1) whether the foreign bank will be subject to any United States federal income tax if it gratuitously guarantees to the Securities Holders the repayment of the Securities, and (2) the federal income tax consequences to the Finance Subsidiary, the foreign bank and the Bank Affiliates if the Finance Subsidiary makes loans to Bank Affiliates.

The issue arises as to whether payments of interest made by the foreign bank (and any Bank Affiliate incorporated in a foreign country) to the Finance Subsidiary are subject to any foreign withholding taxes.[521] If such foreign withholding taxes are imposed, the Finance Subsidiary would probably be entitled to claim a deduction or a tax credit against its United States federal income tax liability for these taxes in accordance with the rules discussed above.

ii. *The Foreign Bank as Obligor of the Securities*

As noted above, the United States federal income tax consequences to a Finance Subsidiary and its parent foreign bank by reason of the Finance Subsidiary's issuance of the Securities depends primarily on whether the Finance Subsidiary or the foreign bank will be treated as the obligor of the Securities for federal income tax purposes. If the form of the issuance of the Securities is respected for such purposes, the Finance Subsidiary would be treated as the obligor of the Securities and no adverse federal income tax consequences should result to either the Finance Subsidiary or the foreign bank. Thus, the annual interest (or discount) income derived by the Finance Subsidiary from the foreign bank or Bank Affiliates with

521. Many foreign jurisdictions impose a withholding tax on interest paid to nonresident persons by entities, including banks, incorporated or resident in such foreign jurisdiction. *See supra* notes 479-84 and accompanying text. Since the Finance Subsidiary typically will be a United States corporation, such foreign withholding taxes may apply to interest paid by the foreign bank to its Finance Subsidiary unless an exemption exists under the internal tax law of the foreign bank's resident country or in a tax treaty between that country and the United States. In the event foreign withholding taxes would be imposed on interest paid by a foreign bank or foreign Bank Affiliate to a Finance Subsidiary, the foreign payor typically is obligated to pay the Finance Subsidiary such additional amounts as are necessary to ensure that the aggregate amount of payments actually received by the Finance Subsidiary is equal to the amount it would have received if the interest were not subject to a foreign withholding tax.

respect to the Finance Subsidiary's loans thereto of the net proceeds of the Securities would generally be offset entirely by deductions allowable to the Finance Subsidiary for the interest (or discount) which it is obligated to pay to the Securities Holders for the year in question and for the annual operating expenses which it is obligated to pay.

If, however, the foreign bank, rather than the Finance Subsidiary, is treated for federal income tax purposes as the obligor of the Securities, and a "worst case" analysis of the federal income tax consequences of such treatment were adopted,[522] the Finance Subsidiary could be subject to federal income taxes on the gross amount of interest it receives from the bank or the Bank Affiliates (because the Finance Subsidiary would be denied a federal income tax deduction for the interest (or discount) which it would pay to the Securities Holders since it would be treated as repaying interest with respect to a debt of the bank).[523] Further, the amount of this interest, less any federal income taxes imposed thereon, could be subject to United States withholding taxes[524] (since the Finance Subsidiary could be

522. This "worst case" analysis would treat (1) the foreign bank as having issued the Securities directly to the Securities Holders, (2) the foreign bank as having contributed the net proceeds of the Securities to the Finance Subsidiary as a capital contribution, and (3) the Finance Subsidiary as having loaned the contributed capital to the bank and/or one or more Bank Affiliates. It is noted that while a strong argument can be made that, under this recharacterization of the transactions, the foreign bank should be treated as having itself loaned the net proceeds of the Securities to the Finance Subsidiary, this deemed "loan" would most likely then be recharacterized as a contribution to the capital of the Finance Subsidiary under applicable debt versus equity principles. *See infra* note 564. The tax consequences resulting under this argument would therefore most probably be the same as the "worst case" analysis noted above. This argument is supported by the comments filed by the Tax Section of the New York State Bar Association in its report on the "final" Treasury Department regulations under I.R.C. § 385 which were issued on December 29, 1980. *See* Report on Section 385 Regulations, New York State Bar Association, Tax Section, n. at 6.

523. Interest on indebtedness paid or accrued generally is deductible only by the taxpayer who is legally obligated to pay the interest. A taxpayer generally is not entitled to deduct interest which it pays with respect to an indebtedness owed by a third party. *See, e.g.*, Crouch v. United States, 692 F.2d 97 (10th Cir. 1982); Schalk Chemical Co. v. Commissioner, 304 F.2d 48 (9th Cir. 1962); Lane v. United States, 535 F. Supp. 397 (S.D. Miss. 1981).

524. Dividends paid by a United States corporation to a foreign stockholder generally are subject to a 30% United States withholding tax (or such lower tax rate as may be provided in a bilateral tax treaty entered into between the United States and the foreign country in which the recipient stockholder is resident). However, under current law dividends paid by a United States corporation which derives more than 80% of its aggregate gross income from sources outside the United States (as determined under the rules set forth in I.R.C. §§ 861, 862 (1982)) during a specified base period (an "80/20 Corporation") are considered non-United States Source Income and thereby statutorily exempt from any United States withholding taxes. *See* I.R.C. §§ 861(a)(2)(A), 862(a)(2), 1441, 1442 (1982). The applicable base period is generally the three-year period ending with the close of the taxable year preceding the year in which the dividend is paid. *Id.* § 861(a)(2)(A). Based on these rules, a Finance Subsidiary

treated as having made a constructive dividend of this amount to the foreign bank by reason of repaying interest with respect to a bank's indebtedness to the Securities Holders).[525] As discussed below, it appears clear that this "worst case" analysis should not be adopted where the Finance Subsidiary makes loans solely to the foreign parent bank. Somewhat less certainty exists in this regard where Bank Affiliates also receive loans from the Finance Subsidiary.

As discussed more fully below, the foreign bank could be treated as the obligor of the Securities for federal income purposes if either (i) the Finance Subsidiary were disregarded as a separate taxable entity for such purposes, (ii) the Finance Subsidiary were treated merely as the agent or "conduit" of the bank in connection with the bank's financing activities in the United States, or (iii) the combination of the relatively nominal equity capital of the Finance Subsidiary and the foreign bank's credit support of the repayment of the Securities to the Securities Holders (*e.g.*, through its direct guarantee of such repayment or by reason of the Bank Undertakings and the third party beneficiary rights of the Securities Holders therein) would cause the Securities Holders to reasonably expect that the Securities would not be repaid by the Finance Subsidiary from its cash flow.

As noted above, the parent foreign bank would be treated for federal income tax purposes as the obligor of the Securities if the Finance Subsidiary were treated as the "alter ego" of the foreign bank and disregarded as a separate entity for such purposes. In this event,

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which loans its funds solely to its foreign parent bank and/or to Bank Affiliates incorporated outside of the United States would qualify under current law as an 80/20 Corporation so that any dividend deemed paid by the Finance Subsidiary to the foreign bank should be treated as non-United States Source Income and exempt from United States withholding taxes. It should be noted, however, that Section 612 of the House Bill proposes to repeal the special income source rules applicable to dividends and interest payable by an 80/20 Corporation, subject to certain limited exceptions.

525. A payment by a corporation of a personal liability of one of its stockholders is treated for federal income tax purposes as if the corporation distributed a taxable dividend (to the extent of the corporation's current and accumulated earnings and profits) to the stockholder in the amount of the payment and the stockholder is treated as having used the proceeds of the dividend to repay its indebtedness. *See, e.g.*, Bayou Verret Land Co. v. Commissioner, 450 F.2d 850 (5th Cir. 1971); Berlin v. Commissioner, 20 T.C.M. (CCH) ¶ 969 (1961).

If the Finance Subsidiary is treated as having received the net proceeds of the Securities as a contribution to capital from the foreign bank, the Finance Subsidiary would have current and accumulated earnings and profits because substantially all of the payments made by the foreign bank and/or a Bank Affiliate to the Finance Subsidiary to permit the Finance Subsidiary to pay the interest (or discount) due on the Securities should be treated for federal income tax purposes as interest paid by the bank or Bank Affiliate with respect to its loans from the Finance Subsidiary (for which the Finance Subsidiary would not have an offsetting deduction).

all of the transactions involving the Finance Subsidiary (including its issuance of the Securities and its loans of the net proceeds thereof to the foreign bank and/or the Bank Affiliates) would be disregarded entirely for federal income tax purposes.

The argument that the Finance Subsidiary is an "alter ego" of the foreign bank is based on the premise that the Finance Subsidiary is not engaged in any business other than acting as a financing vehicle for the bank and the Bank Affiliates.[526] However, there is substantial case law authority supporting the position that a corporation should be recognized as a separate taxable entity for federal income tax purposes if the purpose of the corporation was to carry out substantive business functions, or if it in fact engaged in substantial business activity.[527] Under this case law a subsidiary corporation which is organized solely for the purpose of obtaining external financing for its affiliates and which has no operations other than the issuance of debt obligations and the relending of the proceeds of such offerings to affiliates entities should have a sufficient business purpose (*e.g.*, the provision of certain business and marketing advantages to the foreign bank) to cause it to be recognized as a separate entity for federal income tax purposes. It therefore appears unlikely that the Finance Subsidiary would be disregarded as a separate entity for federal income tax purposes. This conclusion is not affected by the

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526. The "alter ego" doctrine was first espoused in Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), wherein the Supreme Court stated:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity . . . .
>
> In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction. . . .

319 U.S. at 438-39.

527. *See, e.g.*, Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Bass v. Commissioner, 50 T.C. 595 (1968) (Swiss corporation formed by a United States citizen to receive working interests in United States oil and gas properties could not be disregarded for United States tax purposes and, therefore, was a separate entity for such purposes, because the corporation engaged in oil and gas transactions in its own name). *See also* Jackson v. Commissioner, 233 F.2d 289 (2d Cir. 1956); Republic Petroleum Corp. v. United States, 397 F. Supp. 900 (E.D. La. 1975), *aff'd in part and rev'd in part*, 613 F.2d 518 (5th Cir. 1980); Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971), *acq. on another issue*, 1972-2 C.B. 1; Sam Siegel v. Commissioner, 45 T.C. 566 (1966); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582 (1959).

fact that, in most cases, a Finance Subsidiary does not have its own employees or office facilities.[528]

Even if the Finance Subsidiary were to be so disregarded for federal income tax purposes, no adverse federal income tax consequences would result to either the foreign bank or the Finance Subsidiary from the issuance of the Securities. This is because, with reference to the "worst case" analysis discussed above, the Finance Subsidiary would not have any income for federal income tax purposes (since its loans to the foreign bank and the Bank Affiliates would be disregarded for such purposes), and the Finance Subsidiary would not be treated as having paid a constructive dividend to the bank (since the bank would be treated as repaying the Securities directly to the Securities Holders).

Even if the Finance Subsidiary is respected as a separate entity for federal income tax purposes, the parent foreign bank could still be regarded as the obligor of the Securities for such purposes if the Finance Subsidiary were treated merely as the agency or "conduit" of the bank in connection with its obtaining financing in the United States. In the case of "back-to-back" loan arrangements, the Internal Revenue Service has taken the position that the intermediary lender (such as the Finance Subsidiary) will be ignored for federal income tax purposes where (1) the intermediary lender acknowledges that it is acting as a mere agent or conduit for the borrower, (2) the intermediary lender has no independent risk of loss with respect to the financing transactions, and (3) the interest rate payable to the intermediary lender by its borrower (such as the foreign bank and/or the Bank Affiliates) equals the interest rate payable by the intermediary lender to the ultimate lender (i.e., the Securities Holders).[529] There is also some case law authority supporting this agency

528. *See, e.g.*, United States v. Creel, 711 F.2d 575 (5th Cir. 1983), *cert. denied*, 464 U.S. 1044, 104 S. Ct. 714 (1984); Photocircuits Corp. v. United States, 204 Ct. Cl. 821 (1974) (adopting Trial Commissioner's report Reported at 74-2 USTC (CCH) ¶ 9558, at 84,737 (where two Netherlands Antilles corporations organized to handle foreign licensing arrangements for a related United States entity were not disregarded for federal income tax purposes even though both corporations had no operating assets and were operated from the law office of a Curacao attorney).

529. *See* Rev. Rul. 72-514, 1972-2 C.B. 440; Rev. Rul. 55-234, 1955-1 C.B. 217. *See also id.* 76-192, 1976-1 C.B. 205 (channelling loan from foreign subsidiary to its domestic parent through an independent financial institution and another foreign subsidiary was held to be a direct loan by the first foreign subsidiary to its domestic parent). However, the IRS has indicated that it would respect the form of a back-to-back loan transaction where the intermediary lender has independent risk of loss upon default of the ultimate borrower, and the interest rate of the obligation to the ultimate borrower differs from the rate on the ultimate lender's obligations to the intermediary. *Id.* 78-118, 1978-1 C.B. 219.

or conduit treatment under those facts.[530]

In two recent Revenue Rulings the Internal Revenue Service has treated a foreign finance subsidiary of a United States corporation as an agent or "conduit" for the United States parent where the subsidiary acts as the intermediary lender of funds in a "back-to-back" loan arrangement created primarily to avoid the imposition of United States withholding tax on payments of interest by the United States parent.[531] Unlike the "back-to-back" loan arrangements dis-

530. The principal case providing this support is Aiken Indus., Inc. v. Commissioner, 56 T.C. 925 (1971), *acq. on another issue*, 1972-2 C.B. 1.

In *Aiken*, a Bahamian corporation loaned funds to its second-tier United States subsidiary in exchange for the latter's promissory note. Any interest paid by the United States subsidiary to the Bahamian corporation would have been subject to a 30 percent United States withholding tax. In order to take advantage of the exemption from United States withholding taxes on interest income then provided in the United States-Honduras income tax treaty (which was subsequently revoked), the Bahamian corporation assigned the promissory note of its United States affiliate to another second-tier subsidiary which was newly-formed in Honduras, in exchange for the notes of this Honduran corporation. The notes of the Honduran corporation were in the same aggregate principal amount and bore interest at the same rate as the notes of its United States affiliate. The sole income of the Honduran corporation was the interest it received from its United States affiliate and the Honduran corporation remitted all of this interest immediately to its Bahamian corporation in satisfaction of its own interest obligations to the Bahamian corporation.

Sustaining the position of the Commissioner, the Tax Court treated the newly-formed Honduran corporation, which was established principally to avoid United States withholding taxes, as a mere collection agent for the Bahamian corporation. Accordingly, the Court held that United States source interest payments paid to the Honduran corporation were to be treated as paid directly to the Bahamian corporation and subject to United States withholding taxes.

The facts in *Aiken* are somewhat distinguishable from those involving the transactions between a Finance Subsidiary and its parent foreign bank. A pre-existing debt obligation was involved in *Aiken*, the ultimate lender and the ultimate borrower therein were affiliates and identical interest rates were involved on the "back-to-back" loan arrangements in that case. Contrarily, no pre-existing debt exists in the case of loans by the Finance Subsidiary to its affiliates and the Securities Holders would generally not be affiliated with either the Finance Subsidiary or the parent foreign bank. Further, since the "interest" paid by the foreign bank and/or a Bank Affiliate to a Finance Subsidiary generally will be sufficient in amount to enable the Finance Subsidiary to pay all of the interest (or discount) owed on the Securities and all of the costs and expenses incurred by the Finance Subsidiary in issuing the Securities (except any tax liabilities to the Finance Subsidiary resulting from such issuance), the interest income received by a Finance Subsidiary will exceed its interest expense for federal income tax purposes.

531. Rev. Rul. 84-152, 1984-2 C.B. 381 and Rev. Rul. 84-153, 1984-2 C.B. 383, *as modified by* Rev. Rul. 85-163, I.R.B. 1985-41, 25. The thrust of both of these rulings is to prevent the avoidance of United States withholding taxes by the use of a foreign corporation incorporated in a country with a favorable tax treaty with the United States as a conduit in a "back-to-back" loan arrangement. The immediate effect of Revenue Ruling 84-153 was to potentially subject to United States withholding taxes interest paid on approximately $2 billion of debt obligations issued in the Eurobond market between June 22, 1984, and July 18, 1984, by Netherlands Antilles finance subsidiaries of certain United States corporations. The 27-day period affected by Revenue Ruling 84-153 results from a combination of two effective date provisions in the Tax Reform Act of 1984 (sections 127(g)(i) and (3) of P.L. 98-369). On

cussed in the preceding paragraph, the foreign finance subsidiary in these rulings derived a profit on its loans transactions (*i.e.*, the interest rate paid by the United States parent to the finance subsidiary was one percentage point greater than the interest rate paid by the finance subsidiary to the ultimate borrower). Since the foreign finance subsidiary was utilized as an intermediary lender in the borrowing transaction for the primary purpose of avoiding United States withholding tax, the IRS held that any business or economic purpose for using the finance subsidiary was insufficient to overcome the conduit nature of the transaction.[531.1]

Based upon the position it has taken in the other "back-to-back" loan transactions described above, the IRS could seek to treat the Finance Subsidiary as having issued the Securities as an agent or conduit for its parent foreign bank. The Finance Subsidiary does not, however, represent itself to the Securities Holders as having issued the Securities as agent for the foreign bank. The primary purpose for utilizing the Finance Subsidiary as an intermediary lender in the financing transactions is to provide certain marketing and business advantages to the parent foreign bank, and the use of the Finance Subsidiary does not result in any United States tax avoidance (although this use could avoid the foreign withholding taxes which may be imposed if the parent were to issue the Securities directly to the Securities Holders). Accordingly, the better view is that the Finance Subsidiary should be treated for federal income tax purposes as the obligor of the Securities, rather than as the agent or conduit for its parent foreign bank. This view would be strengthened where the Finance Subsidiary derives a profit on its loans of the net proceeds of the securities and otherwise deals at arm's length with the parent

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September 30, 1985 the Internal Revenue Service announced that the holdings in Revenue Rulings 84-152 and 84-153 will not be applied to (1) interest payments made with respect to debt obligations issued prior to October 15, 1984 (the date these rulings were issued by the Internal Revenue Service), and (2) interest payments made with respect to debt obligations issued on or before October 15, 1984 pursuant to a binding written agreement entered into prior to that date, including debt obligations issued upon the exercise of a warrant or upon the conversion of convertible obligations, if such warrant or convertible obligation was issued prior to October 15, 1984. *See* Internal Revenue Service News Release, IR-85-98C (Sept. 30, 1985). This relief is contained in Rev. Rul. 85-163, I.R.B. 1985-41, 25.

531.1. In support of its treatment of the foreign finance subsidiary as a "conduit," the IRS cited Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971), *acq. on another issue*, 1972-2 C.B.1. The IRS cited Gregory v. Helvering, 293 U.S. 465 (1935), as its authority for disregarding the form of the "back-to-back" loan transactions because the primary purpose for using the finance subsidiary as an intermediary lender was to avoid United States withholding taxes. The essence of the holding in the Gregory case is that a transaction will not be given effect for federal income tax purposes unless it serves a purpose other than tax avoidance.

foreign bank (*e.g.*, the Finance Subsidiary reimburses the parent for the Foreign Subsidiary's part-time use of the parent's employees and office facilities).

Finally, even if the participation of the Finance Subsidiary in issuing the securities is not disregarded in determining the federal income tax consequences of the issuance of the Securities, the issue arises as to whether the parent foreign bank, rather than the Finance Subsidiary, would nevertheless be treated as the obligor of the Securities by reason of its direct or indirect credit support of the repayment of the Securities (*e.g.*, as a consequence of either its direct guarantee to the Securities Holders or the Bank Undertakings and the third party beneficiary rights of the Securities Holders therein). Thus, in certain cases the IRS has asserted that a loan to a corporation, the repayment of which is guaranteed by a stockholder of the corporation, will be treated for federal income tax purposes as a loan to the stockholder followed by a capital contribution by the stockholder of the loan proceeds to the corporation.[532] Where the parent foreign bank unconditionally guarantees to the Securities Holders the repayment of the Securities, the IRS could assert that the foreign bank should be treated for federal income tax purposes as having issued the Securities to the Securities Holders and as having contributed the net proceeds thereof to the Finance Subsidiary. Even if the parent foreign bank does not provide the Securities Holders with any direct guarantee of the timely repayment of the Securities, the IRS conceivably could seek to treat the Bank Undertakings and the third party beneficiary rights of the Securities Holders therein as the functional equivalent of such a guarantee.[533]

With respect to loans to a corporation which are guaranteed by the corporation's stockholders, the IRS has asserted its loan recharacterization theory in only a limited number of cases and generally only where the corporation is "thinly-capitalized" (i.e., has an excessive debt-to-equity ratio).[534] *Plantation Patterns, Inc.*[535] is the

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532. *See, e.g.*, Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972); Rev. Rul. 79-4, 1979-1 C.B. 150.

533. There does not appear to be any authority on this point relating directly to these indirect support arrangements between a corporation and its stockholders.

534. Santa Anita Consolidated, Inc. v. Commissioner, 50 T.C. 536 (1968), *acq.*, 1969-2 C.B. 25, is an example of a case involving the federal income tax consequences of a stockholder-guarantee where the debtor corporation was not "thinly-capitalized." The "thin capitalization" doctrine has been primarily applied to recharacterize direct loans made by a stockholder to its corporation as equity. *See* Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX. L. REV. 369 (1971).

535. 462 F.2d 712 (5th Cir. 1972).

leading case involving the issue as to whether a stockholder-guarantor should be treated as the borrower of funds received by the corporation from an unrelated lender and has been cited by the IRS in certain of its pronouncements in this area.[536] However, there is no official pronouncement of the IRS which sets forth the views of the IRS as to the circumstances in which a stockholder-guaranteed loan will be recharacterized as equity capital.

In the cases in which the IRS has sought to treat a stockholder-guarantor as the actual debtor of a loan to its corporation, the courts generally have viewed the key issue as whether or not, at the time the loan was made, the lender had a reasonable expectation that the corporation, rather than the stockholder-guarantor, would repay the loan.[537] The first inquiry generally made by the courts in this regard is to ascertain whether the corporation is thinly-capitalized. If a court does not view a corporation as thinly-capitalized, it generally will hold that the loan to the corporation will not be recharacterized as having been made to the stockholder-guarantor.[538]

Even if, however, the corporation is viewed as thinly-capitalized, the existing cases do not treat the stockholder-guarantor as the borrower of the funds if the corporation has a likely source of cash flow which would enable it to discharge its indebtedness to the lender on a timely basis.[539] Thus, the existence of this cash flow generally is viewed by the courts as strong evidence that the lender had a reasonable expectation at the time the loan was made that the corporation would itself repay its indebtedness.[540] In addition to these factors relating to the corporation's financial condition, courts have also looked to traditional debt versus equity criteria in deciding whether to recharacterize loans by an unrelated third party to a corporation as loans directly to a stockholder-guarantor of the corporation.[541]

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536. *See, e.g.*, Rev. Rul. 79-4, 1979-1 C.B. 150.

537. *See* Liflans Corp. v. United States, 390 F.2d 965 (Ct. Cl. 1968); Blum v. Commissioner, 59 T.C. 436, 440 (1972).

538. *See, e.g.*, Murphy Logging Co. v. United States, 378 F.2d 222, 224 (9th Cir. 1967); Fors Farms, Inc. v. United States, 66-1 U.S.T.C. (CCH) ¶ 9206, at 85,357 (W.D. Wash. 1966).

539. *See supra* note 535.

540. *Id.*

541. These criteria relate primarily to the formal aspects of the loan. The following is a list of some of the factors often cited by courts as weighing in favor of treating an investment in a corporation in the form of a loan debt, rather than equity: (1) the obligation of the corporation to repay the loan is unconditional; (2) the obligation is not subordinate to any other indebtedness of the corporation; (3) the debt instrument evidences a fixed amount of principal owed by the corporation; (4) the debt instrument evidences a fixed rate of interest to be paid by the corporation; (5) the debt instrument evidences a fixed and unconditional date of maturity; and

Thus, in focusing on debt and equity questions relating to loans by a stockholder to its corporation, the courts generally have recognized that companies engaged in a lending or finance business do not require a substantial amount of equity capital and have viewed the debt-to-equity ratio of these companies as of little importance in the relevant debt versus equity analysis (i.e., whether these stockholder loans should be recharacterized for federal income tax purposes as contributions to the equity capital of the corporation).[542] Furthermore, there appear to be no cases in which the IRS has attempted to treat a shareholder-guaranteed loan to a lending or financing company as being a loan to the stockholder-guarantor.

The view that the IRS would not treat the Finance Subsidiary as "thinly-capitalized" despite its nominal equity capital also found support in proposed regulations issued a few years ago by the Treasury Department under Section 385 of the Code (Proposed Section 385 Regulations).[543] While the Proposed Section 385 Regulations subsequently were revoked, the revocation resulted from controversy over provisions thereof other than those which support this view.[544]

Where relevant thereunder, the Proposed Section 385 Regulations provided a "safe harbor test" under which a corporation would not be treated as thinly-capitalized if it satisfied certain debt-to-equity ratio tests (Safe Harbor Test).[545] In the case of a corporation "primarily engaged in a lending or finance business,"[546] the corporation's

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(6) the books of the corporation carry the obligation as a debt of the corporation. *See, e.g.*, John Kelley Co. v. Commissioner, 326 U.S. 521 (1946); Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972). All of the factors cited by courts in favor of treating the corporation as the debtor on the loan, rather than the stockholder-guarantor, would exist with respect to the Finance Subsidiary's indebtedness to the Securities Holders.

542. *See, e.g.*, Security Finance & Loan Co. v. Koehler, 210 F. Supp. 603 (D. Kan. 1962); Jaeger Auto Finance Co. v. Nelson, 191 F. Supp. 693 (E.D. Wis. 1961).

543. The Proposed Section 385 Regulations were published on January 5, 1982. I.R.C. § 385 (1982) authorizes the Treasury Department to issue regulations delineating for all federal income tax purposes whether an investment in a corporation is to be treated as equity capital or indebtedness. Therefore, any Treasury Department regulations issued under I.R.C. § 385 will be "legislative" in nature and generally will be given the force and effect of law unless they either exceed the scope of the power delegated to the Treasury Department, are contrary to the Code or are unreasonable. *See, e.g.*, Panama Refining Co. v. Ryan, 293 U.S. 388 (1935); Joseph Weidenhoff, Inc. v. Commissioner, 32 T.C. 1222 (1959), *acq.*, 1960-2 C.B.7.

544. 48 Fed. Reg. 31,053 (1983). The Proposed Section 385 Regulations are discussed herein because they reflect the recent IRS position on this issue and because it is possible that the IRS may promulgate new regulations under Code Section 385 in the future.

545. *See* Treas. Reg. § 1.385-6(f), 47 Fed. Reg. 147 (1982) (proposed Jan. 5, 1982).

546. For purposes of the Safe Harbor Test, a corporation was treated as "primarily engaged in a lending or finance business" under the rules contained in Treas. Reg. § 1.279-5 (1973). This Regulation provides that a corporation is engaged in a lending or finance business if it is

debt-to-equity ratio[547] would be computed by reducing the aggregate indebtedness and assets of the corporation by the aggregate indebtedness owed to the corporation which arise out of its lending or finance business (Offset Rule).[548] Therefore, the only indebtedness taken into account in computing the relevant debt-to-equity ratio of a lending or finance corporation would be indebtedness not offset by a receivable arising out of the corporation's financing business. Notwithstanding the revocation of the Proposed Section 385 Regulations, the use of the Offset Rule in applying the Safe Harbor Test under these regulations indicates that the IRS generally will not treat as thinly-capitalized a lending or finance company with offsetting receivables and liabilities (such as a Finance Subsidiary).

In any event, a Finance Subsidiary arguably should be treated as the obligor of the Securities even if it were to be treated as "thinly-capitalized." This is because it appears clear that at the time of the issuance of the Securities the Securities Holders would have more than a reasonable expectation that the Finance Subsidiary would repay the Securities in a timely manner from its expected cash flow other than payments under the foreign bank's guarantee or the Bank Undertakings. The Finance Subsidiary would receive this cash flow from the "rollover" of maturing Securities, from the repayment by the foreign bank and/or the Bank Affiliates of their loans from the Finance Subsidiary and, in the event any Bank Affiliate defaulted on its loan repayments to the Finance Subsidiary, from the parent foreign bank under its unconditional guarantee to the Finance Subsidiary of these repayments.

In conclusion, based on the case law authority and analysis discussed above, it appears clear that the Finance Subsidiary, rather than the foreign bank, should be treated as the obligor of the Securities for federal income tax purposes even though the foreign bank would provide direct or indirect support for the Finance Subsidiary's indebtedness to the Securities Holders. This is because (i) since the Finance Subsidiary's activities would involve solely the borrowing and lending of funds, neither the IRS nor the courts would likely

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engaged in "a business of making loans or purchasing or discounting accounts receivable, notes or installment obligations."

547. For purposes of the Proposed § 385 Regulations, a corporation's "equity" equaled the difference between the tax basis of its assets and the amount of its liabilities.

548. It should be noted that it was not entirely clear whether a Finance Subsidiary which constituted an 80/20 Corporation would have been entitled to rely on the Safe Harbor Test (or the Offset Rule) in determining whether it was thinly-capitalized for debt vs. equity purposes. *See* Treas. Reg. § 1.385-2(a) 47 Fed. Reg. 147 (proposed Jan. 5, 1982).

treat the Finance Subsidiary as thinly-capitalized, and (ii) even if the Finance Subsidiary were to be treated as thinly-capitalized, at the time of the issuance of the Securities the Securities Holders would appear to have more than a reasonable expectation that the Finance Subsidiary would repay maturing Securities from its expected cash flow.

Finally, even if the IRS were to treat the parent foreign bank as the obligor of the Securities (whether because the Finance Subsidiary was treated as issuing the Securities as "agent" for the bank or because of the foreign bank's credit support of the repayment of the Securities), no adverse federal income tax consequences should result to either the Finance Subsidiary or the foreign bank (i.e., the "worst case" analysis discussed above should not be adopted) where the Finance Subsidiary makes loans solely to its foreign parent bank. As stated above, where a loan to a corporation is recharacterized as having been made to a stockholder-guarantor, the IRS generally treats the stockholder as having contributed all of the loan proceeds to the capital of the corporation. However, the instances in which the IRS has sought to apply recharacterization have not involved situations in which the loan proceeds are in fact utilized directly by the stockholder-guarantor, rather than the corporation itself. Therefore, even if the parent foreign bank were treated as the obligor of the Securities, since the net proceeds of the Securities would be held only temporarily by the Finance Subsidiary and the parent would have complete and immediate use of these proceeds, it should be concluded that the foreign bank would not be treated as having contributed these net proceeds to the equity capital of the Finance Subsidiary. Therefore, in this situation it appears quite clear that the Finance Subsidiary would have no taxable income for federal income tax purposes and, accordingly, could not properly be treated as having paid a dividend to the foreign bank which would be subject to United States withholding taxes.

Where the parent foreign bank is treated as the obligor of the Securities, the same result should occur where the Finance Subsidiary loans all or a portion of the net proceeds of the Securities directly to one or more Bank Affiliates. Once having concluded that the parent bank should be treated as having itself borrowed money from the Securities Holders, the much better view is that the parent should also be treated as having made the loans to the Bank Affiliates. However, in this situation, the IRS conceivably could treat the bank as having made a contribution of the net proceeds of the Securities to the equity capital of the Finance Subsidiary and the Finance

Subsidiary in turn as having loaned these proceeds to the Bank Affiliates. Under this characterization, the "worst case" analysis discussed above would apply. Thus, the Finance Subsidiary would be subject to federal income taxes on the interest it receives from the foreign bank on these loans (because the Finance Subsidiary would be denied a corresponding tax deduction for the discount which it pays to the Securities Holders),[549] and the amount of this interest, less United States federal income tax thereon, would be treated as a deemed dividend distribution to the foreign bank subject to United States withholding taxes.[550]

iii. *Gratuitous Guarantee by a Foreign Bank*

Assuming the Finance Subsidiary is treated for federal income tax purposes as the obligor of the Securities, a further issue arises as to whether any adverse federal income tax consequences would result from the parent foreign bank's unconditional guarantee of the Finance Subsidiary's repayment of the Securities without receiving a fee from the Finance Subsidiary. Because of the affiliation of the Finance Subsidiary and the foreign bank and the fact that a corporation typically would be required to pay a guarantee fee to an unrelated guarantor, the IRS could take the position that the Finance Subsidiary should be treated for federal income tax purposes as having paid a guarantee fee to the foreign bank.[551]

However, even if the IRS were to take this position, the foreign bank should not be subject to any United States federal income taxation with respect to any guarantee fee it is deemed to receive. This conclusion is not affected by the fact that the foreign bank is treated

549. *See supra* note 523.

550. *See supra* note 525.

551. With respect to two or more corporations owned or controlled by the same interests, I.R.C. § 482 authorizes the Treasury Department to issue regulations providing for the distribution, apportionment or allocation of gross income, deductions, credits or allowances between the two corporations if necessary to prevent the evasion of taxes or to clearly reflect the income of these two corporations. The Treasury Department has issued regulations setting forth detailed rules regarding the application of I.R.C. § 482 (1982).

The purpose of I.R.C. § 482 is to place two affiliated corporations engaging in transactions with each other in the same federal income tax position that they would have been in if they had engaged in the same transactions with an unrelated third party. Thus, the Treasury Regulations provide that the standard to be applied in every case involving I.R.C. § 482 is that of two unrelated corporations dealing with each other on an "arm's length" basis. *See* Treas. Reg. § 1.482-1(b) (1962).

as Engaged in a United States Business for federal income tax purposes.[552]

iv. *Loans to a Bank Affiliate*

A final tax issue arising by reason of a Finance Subsidiary's issuance of Securities is whether any loan of funds by the Finance Subsidiary to a Bank Affiliate would be recharacterized for federal income tax purposes as equity capital of the Bank Affiliate, rather than indebtedness. If such a loan were to be so recharacterized as equity capital of the Bank Affiliate and depending on the stock relationship of the debtor Bank Affiliate to the parent foreign bank,[553] the IRS might argue that the receipt of interest and principal by the Finance Subsidiary on its loan to the Bank Affiliate would be treated as a dividend to the foreign bank for federal income tax purposes.[554] Under this theory the deemed dividend may be subject to United States federal income taxes (to the extent of the current and accumulated earnings and profits of the Bank Affiliate) if the Bank Affiliate is a United States corporation or a foreign corporation Engaged in a United States Business or if the foreign bank is itself Engaged in a United States Business for federal income tax purposes.[555] It is not entirely clear whether this issue could be avoided by having the Finance Subsidiary make loans solely to the foreign bank and by having this bank reloan a portion of the proceeds to the Bank Affiliate.

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552. The foreign bank's provision of the guarantee of the Finance Subsidiary's timely repayment of the Securities should be treated as a service rendered by the foreign bank to the Finance Subsidiary outside of the United States. Accordingly, any guarantee fee deemed realized by the Finance Subsidiary under I.R.C. § 482 would be treated as income derived by the foreign bank from sources outside the United States and should not be subject to any United States tax. This foreign source income would not constitute Effectively Connected Income to the bank even if the bank is treated as Engaged in a United States Business. *See* I.R.C. § 864(c)(4) (1982). *See id.* §§ 862(a)(3), 864(c)(4), 881.

In any event, under the current IRS position the parent foreign bank would not be treated as realizing any service income under I.R.C. § 482 by reason of its gratuitous guarantee of the Securities. *See* Private Letter Ruling 7822005 (Feb. 22, 1978) and Private Letter Ruling 7712289960A (Dec. 28, 1977). This position is based on the conclusion that a parent corporation's provision of a guarantee to a subsidiary does not cause the parent to incur any actual cost and on Treas. Reg. § 1.482-2(b)(3) (1962) which provides for no allocation of income from the Finance Subsidiary to the foreign bank in this situation.

553. This issue would most likely arise if the Bank Affiliate was a wholly-owned subsidiary of the foreign bank.

554. Rev. Rul. 69-301, 1969-1 C.B. 183.

555. *See* I.R.C. §§ 861(a)(2)(B), 864, 1441, and 1442 (1982).

3. *Adjustable Rate Preferred Stock*

As an alternative to issuing debt securities or common stock, many United States banks have issued money market or adjustable rate preferred stock (Adjustable Rate Preferred Stock).[556] Such adjustable rate preferred stock has a preference over the issuer's common stock with respect to dividends and distributions in liquidation of the corporation (to the extent of the sum of the stock's issue price and any accrued but unpaid dividends thereon) but is subordinate to the claims of the general creditors of the bank. Holders of Adjustable Rate Preferred Stock are entitled to receive, when and as declared by the bank's board of directors, cash dividends at a rate which is adjusted for each dividend period (at least quarterly). The applicable dividend rate generally is based on the United States Treasury Bill rate or some other similar index or, in the case of money market preferred shares, the applicable dividend rate is reset periodically by a "Dutch Auction" in which potential buyers set the dividend yield through a bidding process intended to ensure that the shares will trade at approximately its par value. While the term of Adjustable Rate Preferred Stock generally is perpetual, the preferred stock generally is redeemable after a specific number of years at the option of the bank.

The Adjustable Rate Preferred Stock described above offers unique advantages to both the issuer and holders of such securities. For the issuing bank, offerings of this preferred stock constitute a method of raising permanent capital in a cost effective manner. Furthermore, because of the attractiveness of such issues to United States corporate investors, the dividend rate on such stock is generally less than the interest rate that the issuer would have to pay in a debt offering. The principal advantages of Adjustable Rate Preferred Stock to holders thereof that are United States corporations are that they can obtain a market rate of return and, because dividends payable on this preferred stock are eligible for an eighty-five percent dividends received deduction,[557] only fifteen percent of these dividends are includable in their taxable incomes for United States income tax purposes.[558]

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556. *See* Forde, *Adjustable Preferreds Roll On*, AM. BANKER Feb. 28, 1983, at 3.

557. *See supra* note 508.

558. Under I.R.C. § 243 (1982), a corporation is entitled to deduct in computing its United States taxable income 85% of the amount of dividends it receives from domestic corporations. Thus, a corporation is taxed on only 15% of the amount of such dividends it receives. As the maximum tax rate on a corporation is presently 46%, the maximum corporate income tax applicable to dividends qualifying for 85% dividends received deduction is 6.9 % (15% x 46%).

A foreign bank wishing to raise funds in the United States may want to consider the issuance of Adjustable Rate Preferred Stock through a United States banking or other operating subsidiary. The use of a United States subsidiary to issue such stock is crucial in order for United States corporate investors to be entitled to the eighty-five percent dividends received deduction with respect to dividends on the stock. Since dividends paid by a foreign corporation generally do not qualify for the eighty-five percent dividends received deduction, a foreign bank generally would not derive any financing advantages (through lower financing costs) if it were to issue such stock directly.[559]

A foreign bank which did not already have a United States subsidiary to issue the stock could consider the possibility of incorporating its United States branch or agency as a United States corporation or establish a new United States corporation to issue Adjustable Rate Preferred Stock in the United States. It is also crucial that the Adjustable Rate Preferred Stock be issued by a United States corporation which has sufficient earnings and profits for United States tax purposes so that the dividends paid by it to holders of the stock will be treated as "dividends" for United States income tax purposes.[560] Thus, it is important that the issuer of the Adjustable Rate Preferred Stock be an operating company with a source of earnings and profits or a holding company whose subsidiaries generate earnings and profits. A United States banking subsidiary or other United States operating subsidiary would in many cases be an appropriate issuer. The earnings and profits of such a United States subsidiary would include the income received by the United States subsidiary from its use of the proceeds of the preferred stock plus its net income from operations and its other investment income.[561]

Alternatively, Adjustable Rate Preferred Stock could be issued by a United States corporation formed to hold the stock of a United States banking subsidiary of a foreign bank or other United States operating subsidiary of a foreign bank (i.e., the United States issuer, which would be wholly owned by the foreign bank, would be a hold-

559. *See supra* note 508 and accompanying text.

560. Amounts paid by a corporation to its shareholders as dividends are considered "dividends" for United States tax purposes only to the extent of the current and accumulated earnings and profits of the payor corporation. I.R.C. § 316 (1982).

561. Earnings and profits generally means taxable income with certain adjustments designed to reflect the corporation's economic income. For example, tax-exempt interest, while not included in taxable income, is included in earnings and profits. *See* Treas. Reg. § 1.312-6 (1960).

ing company owning all of the stock of the second-tier United States banking subsidiary or other operating subsidiary). Under this structure, the operating subsidiary could pay intercorporate dividends to the United States subsidiary issuing the Adjustable Rate Preferred Stock, which intercorporate dividends would be included in its earnings and profits.[562]

A significant consideration in determining whether to issue Adjustable Rate Preferred Stock, is whether the after-tax cost of issuing such stock is less than the after-tax cost of issuing debt securities. Since, as noted above, interest payments are deductible by a United States corporate issuer while dividend payments are not, the after-tax cost of debt securities (even though the interest rate on the debt securities is higher than the dividend rate on the stock) may be less than the after-tax cost of Adjustable Rate Preferred Stock. However, if the issuing corporation has little or no taxable income (because of net operating losses or because of its receipt of substantial amounts of tax-exempt income), the after-tax cost of a stock offering may be less than the after-tax cost of a debt offering because of the lower dividend rate on the stock.

Another issue to consider in order to insure that United States corporate holders of Adjustable Rate Preferred Stock will be entitled to the eighty-five percent dividends received deduction is whether the stock constitutes equity of the issuer (rather than debt) for United States federal income tax purposes.[563] A number of factors generally are considered in determining whether a particular corporate security is to be treated as "equity or "debt" for United States federal income tax purposes. The following factors have generally been viewed as indicating that a security constitutes "equity" for federal income tax purposes: (i) that no fixed maturity date is provided for the securities; (ii) that the securities provide for no fixed payments in the nature of interest (other than payments which are contingent on earnings or discretionary with the directors of the corporation); and (iii) that the securities are subordinate to the claims of general cred-

562. Such intercorporate dividends would not be included in the taxable income of the recipient corporation. I.R.C. § 243(a)(3) (1982). In lieu of paying intercorporate dividends, the United States subsidiary and the second-tier banking subsidiary could file consolidated federal income tax returns in which case the earnings and profits of the United States subsidiary would include the earnings and profits of the banking subsidiary whether distributed or not. Treas. Reg. § 1.1502-33 (1966).

563. If the preferred stock is treated as "debt" rather than "equity" for United States tax purposes, the "dividends" paid on the stock would be treated as interest for tax purposes and would be fully includable in the taxable income of investor.

itors.[564] Since the adjustable rate preferred stock described above is redeemable only at the option of the issuer, provides for payments of dividends only at the discretion of the board of directors, and is subordinate to the claims of general creditors, such stock should, based on the criteria set forth above, be treated as "equity" for federal income tax purposes. However, to the extent adjustable rate preferred stock contains additional features which are indicative of debt rather than equity, such as a guarantee of repayment by the parent foreign bank or a "keepwell" arrangement between the parent and the United States issuer of the stock or an unconditional mandatory redemption within a few years after issuance,[565] the status of the preferred stock as equity for federal income tax purposes may be subject to question.

VI. Market Considerations

In determining how best to raise capital in the United States, a foreign bank should consider various factors that may affect the marketability of its securities (including those of its branch, agency or subsidiary) offered in the United States. For example, as discussed previously, to facilitate trading in the United States, a foreign

564. The determination of whether a security is to be treated as "debt" or "equity" for United States tax purposes is determined by the facts and circumstances of each particular case; however, courts have generally emphasized the factors noted above as highly significant to this determination. *See* Dobson v. Commissioner, 320 U.S. 489 (1943); John Kelly Co. v. Commissioner, 326 U.S. 521 (1946). These factors are also among those noted in I.R.C. § 385 (1982), which section authorizes the Treasury to adopt Regulations necessary or appropriate to determine whether a security issued by a corporation is to be treated as "debt" or "equity" for tax purposes. The Treasury has not yet issued final regulations under I.R.C. § 385 and has withdrawn several sets of regulations which it had issued in proposed form. *See infra* notes 543-48 and accompanying text. However, one version of the proposed regulations under I.R.C. § 385 provided that preferred stock would be treated as "equity" if it did not provide for "fixed" payments in the nature of either principal or interest. Treas. Reg. § 1.385-10(a), 45 Fed. Reg. 86,438 (1980) (proposed Dec. 31, 1980). Under these proposed Treasury Regulations, payments of principal would be considered "fixed" if the principal sum were payable on demand or were due on definitely ascertainable dates and the holder's rights to receive principal when due could not be impaired without the holder's consent; interest would be considered "fixed" if payable on definitely ascertainable dates and the holder's right to receive interest when due could not be impaired without the holder's consent. It would seem clear that the adjustable rate preferred stock described above would be considered "equity" under this test since the such preferred stock is redeemable only at the option of the issuer and dividends are payable only at the discretion of the issuer's board of directors.

565. While not entirely clear, it is possible that a guarantee of the dividends by, or a "keepwell" arrangement with, the parent foreign bank could cause the preferred stock to be treated as "debt" for United States tax purposes since in that case the payment of dividends could be considered "fixed" under the rationale of the withdrawn Treasury Regulations under I.R.C. § 385 (1982). *See supra* note 563.

bank may wish to offer its equity securities in the United States in the form of ADRs.[566] In addition, a rating of securities may enhance their marketability and may affect their status for purposes of the registration requirements of the Securities Act. Other factors that may affect the marketability of a foreign bank's securities are (i) state laws that restrict purchases of certain securities by institutional purchasers and (ii) listing the securities on a United States securities exchange or including the securities in the NASDAQ system.

A. *Rating Agency Considerations*

1. *Purpose in Obtaining a Rating*

Credit ratings by statistical rating agencies facilitate an investor's evaluation of the creditworthiness of an issuer of securities and the credit quality of the securities offered. Since credit ratings serve a credit risk evaluation function only, they do not constitute the rating agency's recommendation to purchase, sell or hold a particular security. Credit ratings simplify the investment decision-making process, however, by permitting an investor to substitute the judgment of a statistical rating agency with respect to a particular issuer and security for the investor's own independent analysis of the issuer and security.

Certain institutional investors are prohibited from purchasing debt securities that either are not rated or are not rated in a sufficiently high rating category to be considered investment grade quality.[567] Consequently, the credit rating may have a substantial effect on the potential market for an issuer's securities. Moreover, as discussed previously, the achievement of a prime rating for an issuer's commercial paper may aid in determining whether the paper qualifies for the exemption from registration pursuant to Section 3(a)(3) of the Securities Act.[568] The rating of debt securities being registered under the Securities Act also may affect what registration form they may be registered on.[569]

In addition, the rating of securities may have a significant impact on the interest rate an issuer must pay with respect to the securities. Whether a particular securities offering will be cost-effective may,

566. *See supra* notes 16 and 19-20 and accompanying text.
567. *See infra* text accompanying note 575.
568. *See supra* text accompanying notes 558-68.
569. *See supra* text accompanying note 400.

therefore, depend on whether the securities are rated or in which category the securities are rated.

2. *The Rating Process*

The two principal rating agencies in the United States are Standard & Poor's Corporation (S&P) and Moody's Investors Service, Inc. (Moody's). Fitch Investors Service, Inc. and Duff & Phelps, Inc. are other nationally recognized, though less well known, rating agencies. The rating of corporate debt obligations by these agencies is based, in varying degrees, on the capacity of the issuer of the securities to make timely payments in accordance with the terms of the obligations, on the character of the specific obligations, and on whether an investor would be adequately protected in the event of any credit difficulties, including the bankruptcy, insolvency or reorganization of the issuer of the securities, or any other similar arrangement under applicable bankruptcy, insolvency, and other laws affecting creditors' rights generally.

The credit ratings assigned to the securities of a foreign bank (including its branch or agency) or a United States finance subsidiary of a foreign bank will generally be based on an analysis of the credit strength of the foreign bank.[570] The credit ratings assigned to the securities of a United States operating subsidiary of a foreign bank generally will be based on the credit strength of that subsidiary, unless the securities are guaranteed by the parent foreign bank.

If, however, securities issued by a foreign bank or its United States subsidiary are supported by third-party credit support (e.g., by a letter of credit issued by a highly rated bank or a surety bond issued by a highly rated insurance company), the ratings for the securities generally will be based on the credit strength of the supporting institution.[571] So long as the credit documentation assures that the obligation of the credit support institution will not be affected by the bankruptcy, insolvency, reorganization or other similar arrangement of the issuer, the securities supported by the credit support institution will receive the ratings assigned to that institution.[572] Although the securities of a United States operating subsidiary may be rated on the basis of third-party credit support, it is unusual for a

570. *See* STANDARD & POOR'S CREDIT OVERVIEW: CORPORATE AND INTERNATIONAL RATINGS 53 (Aug. 1983) [hereinafter cited as CREDIT OVERVIEW].

571. *See id.* at 61.

572. *See id.* at 62-63.

foreign bank or its United States finance subsidiary to issue securities which are supported in this manner.

The process of obtaining ratings for the initial issuance of securities by a foreign bank, or by a United States subsidiary of a foreign bank based on its parent's credit, may take several months and generally involves payment of a fee and significant disclosure of the business and financial condition of the foreign bank,[573] including lines of credit and other arrangements designed to provide liquidity. All information and documentation provided to the rating agencies for purposes of rating analysis, however, is kept confidential.

Throughout the rating process, the staff of a rating agency may request that the management of the foreign bank be available to speak to or meet with the staff of the rating agency to provide information regarding the foreign bank or its subsidiary, including, for example, applicable regulatory requirements and management policies. In the course of these discussions and meetings, the prospective securities issuer may obtain a preliminary indication of the rating agency's evaluation, at which time the issuer can decide whether to proceed with a formal request for a rating.

The rating agencies evaluate foreign banks, United States finance subsidiaries of foreign banks, and United States operating subsidiaries of foreign banks in accordance with the criteria discussed below.[574]

Long-Term Debt Obligations. The four highest rating categories of S&P and Moody's reflect each agency's determination that the specific long-term debt obligations rated in these categories are investment grade quality.[575] With some exceptions, the rating agencies provide ratings for large corporate bond and preferred stock issues whether or not credit ratings have been requested by the issuers. Although long-term debt obligations of foreign banks generally are rated on the same basis as domestic corporate and municipal issues, S&P currently will not rate the long-term debt issues of foreign

573. *See generally id.* at 76-77.

574. The ensuing analysis deals only with the rating criteria of S&P and Moody's.

575. The four highest rating categories of S&P, which rate the issuer's capacity to pay interest and repay principal, are as follows: AAA (extremely strong), AA (very strong), A (strong), and BBB (adequate). *See* Standard & Poor's Corp., Information and Documentation Requirements for Rating Non-U.S. Issuers 4 (Nov. 1982) [hereinafter cited as Standard & Poor's]. The four highest rating categories of Moody's are as follows: Aaa (best quality, smallest degree of investment risk), Aa (high quality by all standards), A (upper-medium grade obligations, factors giving rise to security are considered adequate), and Baa (interest payments and principal security appear adequate). *See* Moody's Investors Serv., Inc., Moody's Commercial Paper Record 4 (April 1984) [hereinafter cited as Moody's].

banks unless requested to do so.[576] Long-term certificates of deposit issued by foreign banks and United States branches and agencies of foreign banks typically are not rated.

Short-Term Debt Obligations. The rating categories of S&P and Moody's reflect each agency's assessment of the likelihood of timely payment by the issuer or a related supporting institution of a specific short-term debt obligation.[577] Credit ratings for the short-term debt obligations of domestic and foreign issuers, such as commercial paper, are generally provided only upon request.[578] Short-term certificates of deposit of foreign banks and United States branches and agencies of foreign banks generally are not rated.

3. *Considerations Applicable to Foreign Banks*

Prior to assigning a rating for the debt of any foreign bank, the rating agencies determine a rating or implied rating for the country in which the bank is domiciled. The rating by each rating agency for a particular country ordinarily is the highest rating any entity domiciled in that country can receive from the rating agency, based on that country's "country risk."[579]

As in the case of other debt ratings, sovereign debt ratings reflect the rating agency's assessment of the creditworthiness of the sovereign government based on the perceived willingness and capability of the sovereign government to pay its debt in accordance with the terms thereof. The analysis of the country risk, therefore, requires an evaluation of the political and economic factors which bear on the ability of the sovereign government to obtain foreign currency for payment of its foreign debt obligations. In this regard, the rating agencies examine the structure and stability of the political and economic systems of the country and social conditions therein. In practical terms, this sovereign rating ceiling means that a financially sound

576. CREDIT OVERVIEW, *supra* note 570, at 8.

577. S&P's short-term rating categories, which rate the issuer's capacity for timely payment, are as follows: A (greatest capacity), A-1 (overwhelming or very strong), A-2 (strong), A-3 (satisfactory), B (adequate), C (doubtful), and D (in default or expected to be in default upon maturity). *See* Standard & Poor's, *supra* note 575. Moody's short-term rating categories (all of which indicate investment grade quality) rate the issuer's capacity for repayment as follows: Prime-1 (superior), Prime-2 (strong), and Prime-3 (acceptable). *See* Moody's, *supra* note 575.

578. CREDIT OVERVIEW, *supra* note 570, at 8.

579. According to S&P: "Broadly defined, country risk is the probability of incurring a loss on a cross-country claim due to events which are to a certain extent under the control of the government." *Id.* at 76.

foreign bank can be deprived of the highest ratings as a result of uncertainties regarding its country of domicile.[580]

Each rating agency's analysis of the debt repayment capacity of a foreign bank for purposes of determining an appropriate rating involves consideration of certain additional quantitative and qualitative criteria. The quantitative criteria evaluated by the rating agencies include asset quality, asset/liability control, profitability, and capital adequacy. The qualitative factors identified by the rating agencies include the strength of the country of domicile, the bank's importance to the country's financial system, market characteristics, and corporate structure.[581] In addition, according to S&P, "the most important subjective evaluation is the evaluation of management within the context of the issuer's competitive position and future plans."[582]

The rating agencies require that foreign banks provide financial statements. Although the rating agencies do not require that foreign banks conform their financial statements to United States generally accepted accounting principles, the agencies require sufficient information regarding the financial condition and operation of a foreign bank to enable them to evaluate and compare the bank with other similar banks. The rating agencies acknowledge, however, that meaningful comparison is not always possible because of different accounting practices, regulations and standards applied in various countries.[583]

The rating agencies have certain additional documentary requirements with respect to foreign banks.[584] The rating agencies also require that a foreign bank intending to issue securities in the United States consent to the jurisdiction of certain courts in the United States and appoint an agent for service of process in any action, suit or proceeding brought against the foreign bank in the specified courts arising from or in connection with the debt issuance.[585] In addition, before the rating agencies will release their respective rat-

580. *See generally id.* at 71-74.

581. *Id.* at 76.

582. *Id.* at 49. The emphasis on national risk assessment derives from a determination that the repayment capability of United States dollar-denominated obligations by a non-dollar based bank is a function of that bank's access to United States dollars. The rating agencies assess whether a particular foreign bank could expect to receive the support from its government and central bank in difficult periods, as well as the extent to which regulatory controls imposed thereon adversely affect the foreign bank's profitability and ability to generate capital.

583. *Id.* at 77.

584. *See* Standard & Poor's, *supra* note 575, at 18-22.

585. *Id.* at 20.

ings, the agencies require delivery to them of an opinion of counsel.[586]

With respect to commercial paper issues, the rating agencies also may require that the foreign bank obtain lines of credit from banks to provide liquidity for payment of the foreign bank's commercial paper in the event of a disruption in the commercial paper market or other problem which adversely affects the ability of the foreign bank to pay the commercial paper at maturity.[587] Back-up credit facilities generally are not required, however, if the foreign bank obtains a high credit rating and maintains a branch or agency in the United States to provide the foreign bank with an alternative source of funding.

4. *Considerations Applicable to a United States Finance Subsidiary*

The credit ratings of a United States finance subsidiary of a foreign bank organized solely to issue debt securities in the United States and lend the proceeds of sale of such debt securities to its parent are based primarily on the credit support arrangement between the parent and its subsidiary.[588] In most cases, therefore, the credit ratings of the subsidiary will coincide with the credit ratings of the parent foreign bank.

If the securities of a United States finance subsidiary are guaranteed by its parent foreign bank, the rating agency requirements generally are not significantly different than the requirements applicable to a direct issuance of securities by the parent foreign bank. The rating agencies, however, have been concerned that a keepwell arrangement[589] may not fully protect the holders of a subsidiary's debt securities as well as a guarantee by a foreign bank of the subsidiary's securities. To alleviate that concern, the rating agencies have required that a foreign bank using a keepwell arrangement expressly acknowledge that the holders of debt securities issued by its finance

586. *See id.* The opinion must provide that, among other things: (i) the debt obligation of the foreign bank constitutes a legal, valid, binding and enforceable obligation, (ii) the obligation of the foreign bank would be directly enforceable by a holder of such debt against the foreign bank in the courts of the country of the bank's domicile, (iii) a judgment rendered by a United States court which had proper jurisdiction over the foreign bank in connection with the debt issuance would be upheld by the courts in the country of the bank's domicile, and (iv) the foreign bank's consent to the jurisdiction of specified courts in the United States is of legal and binding effect.

587. *See id.*

588. *See* CREDIT OVERVIEW, *supra* note 570, at 53. For a discussion of alternative credit support arrangements, *see supra* note 256 and accompanying text.

589. *See supra* note 256.

subsidiary are third-party beneficiaries of the foreign bank's undertaking to provide funds to the subsidiary to satisfy its obligations, including its liabilities in respect of any debt securities. This undertaking must be irrevocable until all of the debt securities issued by the finance subsidiary are paid in full. In addition, the rating agencies have required additional information concerning the power and authority of the foreign bank to enter into keepwell arrangements and evidence that the bank has obtained all necessary regulatory approvals for the arrangement in its country of domicile.

5. *Considerations Applicable to a United States Operating Subsidiary*

As in the case of a United States finance subsidiary of a foreign bank, if the securities of a United States operating subsidiary of a foreign bank are guaranteed or otherwise supported by its parent foreign bank, the ratings for the securities generally will be based on the credit ratings assigned to the foreign bank. On the other hand, if the securities are not guaranteed by the parent foreign bank, the credit ratings will be based on the rating agency's analysis of the creditworthiness of the operating subsidiary.[590]

The rating criteria utilized by the agencies to assign ratings to the securities of a United States operating subsidiary of a foreign bank in these circumstances are the same as the criteria applicable to a domestic issuer of securities engaged in the same business. These criteria, which are beyond the scope of this article, involve an analysis of, among other things, the issuer's financial condition and qualitative factors such as location, market position, and public confidence in the issuer.[591]

B. *Legal Investment Laws*

Legal investment laws exist in every jurisdiction of the United States and limit the types of obligations in which various entities, including fiduciaries and financial institutions such as domestic banks and thrifts, may legally invest. From a marketing point of view, legal investment laws may have a considerable impact on a foreign bank because the laws permit investments in the foreign bank's obligations to a greater or lesser extent depending on whether the obligations are issued by the foreign bank directly, through a

590. *Cf.* CREDIT OVERVIEW, *supra* note 570, at 53.

591. *See id.* at 46-50.

United States branch or agency of the foreign bank, or through a United States subsidiary of the foreign bank.

Of the three options, the least desirable from the point of view of legal investment laws is to have the foreign bank issue the obligations directly. While five jurisdictions[592] expressly permit investments to be made by local banks and thrift institutions in obligations of a foreign bank, the legal investment laws in the other jurisdictions do not specifically authorize such investments to be made or are unclear as to whether such investments may be made.

A number of jurisdictions whose legal investment laws are unclear with respect to the authority of depository institutions to invest directly in the obligations of foreign banks have catchall provisions authorizing investments into which a "prudent investor" would enter.[593] Since the prudent investor standard is, by design, a flexible one, it might be possible for a depository institution to invest directly in the obligations of a foreign bank under this form of authorization. Since the appropriateness of any particular investment would depend on factors specific to the transaction involved, however, it is difficult to make any general conclusions about whether investments in the obligations of foreign banks are permissible under this standard. Other jurisdictions authorize investments by depository institutions in the direct obligations of foreign banks only with the permission of a designated state banking official[594] or only if the obligations have a rating above a specified rating category.[595]

In contrast to the issuance of foreign bank obligations directly by the foreign bank, issuances of securities by a United States branch or agency of a foreign bank are expressly authorized investments for

592. LA. REV. STAT. 'ANN. § 6:323 (West 1951) (authorized investments for banks); TENN. CODE ANN. § 45-2-607(6) (Supp. 1980) (authorized investments for banks); CAL. FIN. CODE § 3580 (West Supp. 1984) (authorized investments for banks with the consent of the superintendent); MICH. COMP. LAWS ANN. § 487.461(1)(c) (West 1967) (authorized investments for banks with the permission of the Commissioner); ARIZ. REV. STAT. ANN. § 6-19.A.2 (1974) (authorized investments for banks with the consent of the superintendent).

593. *See, e.g.*, ALASKA STAT. § 06.15.270 (1978) (authorized investments for mutual banks); CAL. FIN. CODE ANN. § 7250 (West Supp. 1984) (authorized investments for savings and loan associations); ME. REV. STAT. ANN. tit. 9-B, § 556 (West Supp. 1984) (authorized investments for savings banks, savings and loan associations); NEV. REV. STAT § 662.065 (1983) (authorized investments for banks in "private securities"); N.H. REV. STAT ANN. § 387:18 (1983) (prudent investments).

594. ALASKA STAT. § 06.30.610(9) (1978) (authorized investments for savings and loan associations); IDAHO CODE § 26-1929(2)(c) (1977) (authorized investments for savings and loan associations); KAN. STAT. ANN. § 9-1101(13) (1983) (authorized investments for banks).

595. *See, e.g.*, ARIZ. REV. STAT. ANN. § 6-322.3 (1983) (authorized investments for savings banks); N.D. CENT. CODE § 6-03-47.2(1) (1975) (authorized investments for banks).

financial institutions in a majority of jurisdictions.[596] In those jurisdictions in which investments in obligations of a foreign bank's United States branch or agency are not expressly authorized, the obligations of a foreign bank's branch or agency may be authorized investments under "prudent investor" provisions of the type discussed above.

The most preferable option from the point of view of legal investment laws is to have the foreign bank's obligations issued through a United States finance or other subsidiary of a foreign bank. The vast majority of United States jurisdictions authorize investments in such a subsidiary.[597] In those few jurisdictions in which investments in the obligations of a United States subsidiary of a foreign bank are not expressly authorized, the obligations of the subsidiary may be authorized investments under the "prudent investor" provisions of the type discussed above or with the approval of designated state banking officials.

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596. Jurisdictions allowing banks to invest in obligations of a foreign bank's United States branch or agency include: Alabama, Arizona, Arkansas, California, Delaware, District of Columbia, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Puerto Rico, South Carolina, South Dakota, Tennessee, Texas, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

Savings and loan associations may invest in the obligations of a foreign bank's United States branch or agency in the following jurisdictions: Alabama, Arizona, California, Colorado, Florida, Georgia, Hawaii, Illinois, Kentucky, Maine, Michigan, Montana, Nebraska, Nevada, New Jersey, New York, North Carolina, North Dakota, South Carolina, Texas, Vermont, Virginia, Washington, West Virginia and Wyoming.

597. The following forty-eight jurisdictions allow investments by banks in obligations issued by a United States corporation, including the finance subsidiary of a foreign bank: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Nevada, Michigan, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

Jurisdictions which permit savings and loan associations to invest in obligations issued by a United States corporation, including the finance subsidiary of a foreign bank, include: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Hawaii, Illinois, Indiana, Kentucky, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Utah, Vermont, Virginia, Washington, West Virginia and Wyoming.

C. *Listing Considerations*

Another factor that can affect the marketability of securities of a foreign bank or its United States subsidiary is the availability of a secondary market for the securities. In this regard, securities may be listed on a stock exchange, such as the New York Stock Exchange (NYSE), or included in NASDAQ, and automated quotation system for securities traded in the over-the-counter (OTC) market.[598]

The NYSE accounts for the largest total dollar volume of trading of any of the exchanges and, therefore, tends to be the most attractive exchange for foreign issuers.[599] Stock exchanges and the NASDAQ system differ in several ways. The principal difference is that, while transactions are actually consummated on the floor of an exchange, the NASDAQ system serves as a quotation and price information service to broker-dealers who execute transactions over the telephone.

1. *NYSE Listing Requirements*

A foreign bank issuer may qualify to have its equity securities or ADRs for its equity securities listed on the NYSE based on either the NYSE minimum numerical standards applicable to domestic companies (Domestic Listing Standards) or on the NYSE minimum numerical standards applicable only to non-United States companies (the Alternative Listing Standards).[600] A United States finance or other subsidiary of a foreign bank may qualify only under the Domestic Listing Standards.

The following numerical criteria, which focus on the distribution of securities in the United States, must be met in order for a foreign

598. Listing securities on an exchange or including them in NASDAQ tends to enhance marketability in several ways. First, listing on an exchange or inclusion in NASDAQ facilitates the distribution of securities by assuring investors of a market for public appraisal of prices and by aiding investors in locating a market for subsequent resale. Second, listing on an exchange or inclusion in NASDAQ increases the number and geographic distribution of security holders. Finally, listing on an exchange or inclusion in NASDAQ aids the issuer in determining the price at which additional securities might be sold.

599. The other principal stock exchange in the United States is the American Stock Exchange Inc. (AMEX). In addition, there are a number of regional exchanges which account for only a small share of total exchange trading.

600. *See New York Stock Exchange Listed Company Manual* [hereinafter cited as NYSE *Listed Company Manual*] (¶ P)101.00-102.01, 103.00-103.01 (1983). A third set of listing criteria is available for companies registered under the Investment Company Act or the Small Business Investment Act of 1958. *Id.* at ¶ 102.02. Banco Central, S.A., a Spanish bank, has sponsored ADRs, representing its common stock, that are listed on the NYSE. In addition, the debt securities guaranteed by Barclays PLC and by National Westminster Bank PLC, British banking organizations, have been listed on the NYSE.

bank or its United States finance or other subsidiary to qualify to list their securities under the NYSE Domestic Listing Standards: (i) there must be at least 2,000 record or beneficial holders of 100 shares or more in the United States; or, if there has been an average United States monthly trading volume of 100,000 shares during the most recent six-month period, 2,200 total shareholders; (ii) at least 1,100,000 shares must be publicly held in the United States; (iii) the aggregate market value of publicly held shares in the United States must equal at least $18,000,000 (this amount is subject to adjustment depending on market conditions); and (iv) either the demonstrated earning power, before federal income taxes and under competitive conditions, must equal at least $2,500,000 in the latest fiscal year and at least $2,000,000 in each of the preceding two fiscal years or pre-tax income for the last three years (each of which must be profitable) must be at least $6,500,000, with pre-tax income for the most recent year of at least $4,500,000.[601] A foreign bank issuer may also qualify to have its debt securities or ADRs for its debt securities listed on the NYSE, in which case only some of the numerical standards under the Domestic Listing Standards would apply.

The Alternative Listing Standards, which focus on worldwide rather than United States distribution of shares, are designed to encourage major foreign issuers to list their securities on the NYSE. The following numerical criteria must be met in order for a foreign bank to qualify to list its securities under the NYSE Alternative Listing Standards: (i) there must be 5,000 holders of 100 shares or more worldwide; (ii) at least 2,500,000 shares must be publicly held worldwide; (iii) the market value of publicly held shares must equal at least $100,000,000 worldwide; (iv) net tangible assets must equal at least $100,000,000 worldwide; and (v) pre-tax income must equal at least $100,000,000, cumulatively over the previous three years, with a $25,000,000 minimum for any one of the three previous years.[602]

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601. *Id.* at ¶ 102.01. While greater emphasis is placed on market value, an additional measure of size is $18,000,000 in net tangible assets. In addition to minimum numerical standards, other factors are taken into consideration. For example, a company must be a going concern or be the successor to a going concern. The NYSE also places emphasis on the degree of national interest in a company, the character of the market for the company's products, the company's relative stability and position in its industry, and whether or not the company is engaged in an expanding industry with prospects for maintaining its position.

602. *Id.* at ¶ 103.01. The NYSE recognizes that, because the use of bearer shares by foreign issuers is widespread, a foreign issuer might have difficulty showing that it has the required number of shareholders. In that case, sponsorship by an NYSE member firm as to the

In addition to the numerical criteria discussed above, all companies authorized for listing on the NYSE, whether domestic or foreign, must meet certain further requirements. First, before a company's securities may be admitted for trading on the NYSE, the securities must be registered under the Exchange Act.[603] Additional obligations of listed companies include the following: (i) publication and distribution to shareholders of an annual report containing financial statements of the company and its subsidiaries;[604] (ii) publication of interim earnings statements;[605] (iii) adherence to certain standards of corporate responsibility, integrity, and accountability to shareholders, including, among other things, holding annual meetings, having no more than three classes of directors, and avoiding relationships that might present a conflict of interest;[606] (iv) solicitation of proxies in connection with all meetings of shareholders;[607] and (v) maintenance, in New York City, of facilities for servicing listed securities.[608]

The NYSE has not set any minimum numerical criteria for listing the debt securities of either foreign or domestic issuers. The debt issue must, however, be of sufficient size and distribution to warrant trading on the NYSE. Moreover, the NYSE will delist a debt security if the aggregate market value or principal amount that is publicly held is less than $1,000,000.[609]

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liquidity and depth of market for the foreign issuer's shares may substitute for documentation concerning the number of shareholders. *Id.* at 103.03.

The AMEX provides foreign issuer alternate listing requirements that are similar to, but less burdensome than, those of the NYSE. The criteria are intended to be used as a guide rather than as a set of inflexible rules. *See American Stock Exchange Guide, Listing Standards, Policies and Requirements*, § 110. The securities of a foreign issuer will be eligible for listing on the AMEX if the following criteria are met: (i) there are 2,000 holders of 100 shares or more worldwide; (ii) at least 1,000,000 shares are publicly held worldwide; (iii) the aggregate market value of publicly held shares is at least $20,000,000 worldwide; (iv) the issuer's tangible net worth is at least $25,000,000; and (v) the issuer's pre-tax income is $30,000,000 cumulatively over the previous three years, with a $7,500,000 minimum in each year. *Id.*

603. NYSE Listed Company Manual, *supra* note 600, at ¶ 702.06.

604. *Id.* at ¶ 203.01.

605. *Id.* at ¶ 203.02.

606. *Id.* at ¶¶ 301.00, 304.00, 307.00.

607. *Id.* at ¶ 402.00-402.10.

608. *Id.* at ¶ 601.00.

609. *Id.* at ¶ 703.06. In addition, debt securities must be issued in $1,000 denominations, there must not be any charge to holders for registration or transfer, and certain provisions must be included in the trust indenture. *Id.*

2. *Requirements For Inclusion in NASDAQ*

The equity securities, including ADRs and debt convertible into equity, of a foreign bank or its United States or other finance subsidiary may be included in NASDAQ if those securities meet certain criteria.[610] Generally, the criteria applicable to domestic issuers also are applicable to foreign issuers.[611]

The standards for the initial inclusion of securities in NASDAQ include the following. First, securities of a foreign issuer must be registered under Section 12 of the Exchange Act.[612] Second, there must be at least two market makers in the security.[613] Third, in the case of stock, there must be at least 100,000 shares which are publicly held, while, in the case of convertible debt, the principal amount outstanding must be equal to at least $10,000,000. Fourth, the issuer's total assets must equal at least $2,000,000, and its total capital and surplus must equal at least $1,000,000. Finally, there must be at least 300 holders of the security.[614]

Alternatively, a new issue of securities that are not registered under the Exchange Act is eligible to be included in NASDAQ on the day that the Securities Act registration statement is declared effective by the SEC, provided all of the other criteria above are satisfied. To remain in NASDAQ, the securities must become registered under the Exchange Act within 120 days after the last day of the issuer's fiscal year during which the Securities Act registration statement became effective.[615]

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610. For a definition of equity securities, see 17 C.F.R. § 240.3a11-1 (1985).

611. Schedule D, *supra* note 145, at 1139-42, sets forth the requirements for including in NASDAQ the securities of foreign and domestic issuers. Although Schedule D provides a different standard for the securities of foreign issuers which are subject only to § 15(d) of the Securities Act than for the securities of foreign issuers which are subject to § 12(g) of the Exchange Act, recent conversations with the NASD staff indicate that, in light of the SEC's revisions to Exchange Act Rule 12g3-2 (discussed *supra* notes 147-53 and accompanying text), the NASD now administratively requires that all foreign issuers register under § 12(g) and comply with the Schedule D requirements for domestic issuers. The NASD is in the process of revising Schedule D to reflect the current administrative position. Prior to the SEC's revisions to Exchange Act Rule 12g3-2, ADRs representing the equity securities of a few foreign banks and bank holding companies were included, and continue to be included, in the NASDAQ System.

612. *See supra* note 611.

613. Schedule D, *supra* note 145, at 1140. Section 3(a)(38) of the Exchange Act defines a "market maker" as a broker-dealer who holds himself out "as being willing to buy and sell [a] security for his own account on a regular or continuous basis." 15 U.S.C. § 78c(a)(38) (1982).

614. Schedule D, *supra* note 145, at 1140-41.

615. *Id.* at 1139. Once a security has been included in NASDAQ, an issuer must comply with the following maintenance requirements, which are less stringent than the requirements for initial inclusion. First, only one market maker in a security is required. Second, in the case

of convertible debt, the issuer is required to maintain an outstanding principal amount of only $5,000,000. Third, assets need equal only $750,000 and capital and surplus need equal only $375,000. Finally, the requirements that there be 300 holders of a security and, in the case of stock, that there be 100,000 publicly held shares, remain in force after inclusion in NASDAQ. *Id.* at 1140-41.