International Banking and Finance

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The following contains the 1999 Report of the Section's International Banking and Finance Committee for this issue. This report addresses four areas: (1) U.S. money laundering developments; (2) the new U.S. financial modernization legislation; (3) selective Mexican developments; and (4) selective Canadian developments. A separate Committee Report on international insurance developments will be contained in this issue.

I. United States: International Money Laundering Regulation in 1999

This past year (1999) saw a significant increase in attention paid to money laundering and related financial crimes by the legislative and executive branches of the government, as well as by the general public. Long-simmering investigations of private banking relationships between prominent banks and public figures in Mexico and other Latin American countries continued. In August 1999, dramatic headlines cited an ongoing investigation of billions of dollars of suspect Russian money passing through accounts at the Bank of New York, leading to suspensions, dismissals, and criminal charges against various parties connected with the accounts through which the money flowed. The Bank of New York itself, as of this writing, has not been charged with any wrongdoing and is cooperating with the investigation. In the past, however, serious penalties have been imposed on banks found to

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have violated money laundering rules. For example, in 1985, the Bank of Boston was fined $500,000, and Crocker National was fined $2,250,000.

"Money laundering," as the term is commonly used, is a loosely defined concept involving the use of legitimate financial channels to facilitate illegal enterprises, in particular by disguising (laundering) the origin of funds initially derived from criminal activity. Focusing on the financial aspect of criminal activity as an enforcement "choke point" in the war against crime has a long tradition in the United States, dating at least from the successful tax evasion prosecutions early in this century of gangsters who could not be convicted of the "predicate acts" that brought them their untaxed loot. International aspects of the problem of money laundering have, up until this year, focused primarily on the war on drugs. Recent events, however, have shifted the focus to the potentially more problematic issue of official corruption outside the United States.

The pre-1999 state of legislation and regulation related to money laundering could hardly be called undeveloped. In addition to the Bank Secrecy Act (which had its origins in 1970 as the Currency and Foreign Transaction Reporting Act), requiring the reporting of suspect activity and providing civil and criminal penalties against banks that fail to do so, we already have on the books the Money Laundering Control Act of 1986, the Money Laundering Prosecution Improvements Act of 1988, the Annunzio-Wylie Anti-Money Laundering Act of 1992, the Money Laundering Suppression Act of 1994, and the Money Laundering and Financial Crimes Strategy Act of 1998, as well as their attendant regulations, required studies, and reports. History would indicate, then, that within just a few more years yet more anti-money laundering legislation should be placed on the books.

The current structure of money laundering legislation and regulation in the United States focuses on the concepts of (1) required reporting of certain suspect transactions (which is effected mainly through the Bank Secrecy Act and related legislation) and (2) the actual criminalization of dealing with funds derived from illegal activity. The basics of this prohibition were first set forth in the Money Laundering Control Act of 1986;[1] in general, the statute prohibits transactions involving proceeds of "specified unlawful activity":

(1) with the "intent to promote" the specified unlawful activity;
(2) knowing that the transaction is designed to "conceal" the "nature, the location, the source, the ownership, or the control" of the funds; or
(3) with the intent to "avoid a transaction reporting requirement [as under the Bank Secrecy Act]."[2]

Detailed definitions are provided, as well as severe civil and criminal penalties, including (as of 1992) the so-called "corporate death penalty" provision: under certain circumstances, a bank found guilty of criminal money laundering or failure to report transactions as required may have its charter revoked and be forced to go out of business.

These laws, and the detailed regulatory structure supporting them, are evidently not thought to be sufficient to combat international money laundering as currently practiced. In 1999, legislative concern about the problem of offshore criminals using the U.S. financial system led to a number of proposals. Bills focusing on money laundering in international financial transactions pending before the 106th Congress at the end of 1999 included those

1. Money Laundering Control Act of 1986, 18 U.S.C. §§ 1956-57 (1994).
2. *Id.* § 1965(a)(1-3) (1994).

introduced by Representatives Leach (H.R. 2896) and Waters (H.R. 2905), and Senator Levin (S. 1920). The Department of the Treasury has also submitted its own proposed legislation which, among other things, would expand the list of offenses upon which money laundering prosecutions can be based (the predicate acts) and give federal courts "long-arm" jurisdiction over foreign banks that violate money laundering laws when they do business in the United States. In September 1999, responding to the 1998 Act, the Department of the Treasury and the Department of Justice somewhat belatedly promulgated their National Money Laundering Strategy for 1999 (the Strategy), outlining a broad range of initiatives to combat perceived abuses of the financial system by those seeking to protect and conceal their ill-gotten gains. While the focus of this report was not exclusively international activity, international issues were prominently addressed. The Strategy concentrated on the use of existing laws and regulatory powers to combat the problem.

Among the newly proposed bills, however, H.R. 2896, the "Foreign Money Laundering Deterrence and Anticorruption Act" (the Leach Bill), attracted the most attention.[3] While all would laud its focus on acting to prevent corrupt foreign officials and businessmen from using the U.S. financial system, industry participants and observers noted the possibility of unintended collateral damage that could unduly impact legitimate business and handicap firms in their competition with their large overseas rivals, while ultimately doing little more than would be possible under the current state of the law to suppress and punish criminal activity.

Section 3 of the Leach Bill has been referred to as the "know your foreign customer" provision and has revived unhappy memories of the recently proposed (and then abandoned) domestic "Know Your Customer" regulations. It prohibits financial institutions from maintaining accounts for non-publicly-traded "foreign entities" and their representatives unless the institution "identifies, and maintains a record of the identity of, each person having a direct or beneficial interest in the account."[4] Careful readers immediately noted that this provision would be a trap only for the unwary; by using a friendly front corporation to open the account, the prohibition could be entirely evaded. Indeed, in the Bank of New York case, the entities involved directly with the bank were shell corporations, and it is not clear whether this provision would even have been applicable.

Definitional uncertainties and the potential for over-broad application were also a source of worry in section 3; in particular, the concept of "beneficial owner" caused concern. Depending on how deep one chooses to dig, "beneficial owner" could extend to all of the shareholders of a company, all of the holders of a mutual fund, or all of the limited partners of a partnership. Indeed, in the case of trusts, it would not be uncommon if many beneficiaries had not yet, in fact, been born. Under these circumstances, information gathering requirements inevitably cause concern.

But the primary issue raised by the "know your customer" provisions of the Leach Bill centered upon what appeared to be inevitable conflicts with the bank secrecy laws of other jurisdictions, such as those of the Cayman Islands. Many jurisdictions prohibit the transfer of customer information outside of the home jurisdiction, placing institutions operating internationally in situations of potential irreconcilable conflict.

3. Foreign Money Laundering Deterrence and Anticorruption Act, H.R. 2876, 106th Congress (1999) [hereinafter Leach Bill].
4. *Id.*

The Leach Bill also proposes various changes in the provisions of the Bank Secrecy Act to extend immunities and encourage filing of Suspicious Activity Reports (section 5). Provisions regulating maintenance of correspondent banking relationships with entities deemed not subject to comprehensive and effective supervision are also included (section 3); these provisions revived the problem, present in other aspects of bank regulation, of the division of responsibility between industry and the various concerned regulators as to how and by whom "bad" jurisdictions or "bad" entities should be designated.

One very important change in existing money laundering legislation proposed by the Leach Bill is found in a single word included in section 6, "fraud." Money laundering has always been understood to involve not every crime as defined in all jurisdictions, but only designated "predicate acts," things such as drug crimes, kidnaping, terrorism, and the like. Section 6 of the Leach Bill would add "fraud, or any scheme to defraud, committed against a foreign government or foreign governmental entity."[5] While anticorruption is a key purpose of the Leach Bill, and in principle it is hard to argue against, once more it appears that the devil is in the details. Until now, one offense never included as a predicate act for international money laundering purposes has been tax fraud, but the concept of "fraud . . . against a foreign government" would clearly seem to include tax evasion, and would in theory put banks in the role of agents for the U.S. government in the business of enforcing every jot and tittle of foreign tax codes.

This broad definition of "fraud . . . against a foreign government" included in the Leach Bill brings to the fore one of the key current problems in money laundering, the need to distinguish between money laundering and flight capital, and the question of the proper role of offshore financial centers. Questions of extraterritorial reach of laws, and conflict between the legal requirements of offshore financial centers and the laws of some, but not all, of the home countries of banks operating offshore are also raised. Indeed, it might be possible to find inconsistencies with other laws, as for example where compliance with antiboycott laws might be seen as involving a scheme to evade the targeted foreign boycott, and hence part of a fraud on a foreign government, and hence a violation of the Leach Bill. Lawyers for international financial institutions will need to view with care the progress of the Leach Bill and other money laundering initiatives so as to properly advise their clients.

Related money laundering developments included the National Money Laundering Strategy for 1999, promulgated jointly by the Justice and Treasury Departments as called for under the 1998 money laundering legislation. The Strategy focused principally on the ways current legislation and regulatory powers can be used to support the fight against money laundering, setting forth four general goals: (1) Strengthening Domestic Enforcement to Disrupt the Flow of Illicit Money, (2) Enhancing Regulatory and Cooperative Public-Private Efforts to Prevent Money Laundering, (3) Strengthening Partnerships With State and Local Governments to Fight Money Laundering Throughout the United States, and (4) Strengthening International Cooperation to Disrupt the Global Flow of Illicit Money.[6]

This last goal is of course of particular interest to international practitioners. A constant theme of international money laundering enforcement efforts, and so often elsewhere in

5. *Id.*

6. *See* National Money Laundering for 1999, Dep't Treasury, Press Release (Sept. 23, 1999) (visited June 19, 2000) <http://www.treas.gov/press/releases/docs/money.pdf>.

international law, is the difficulty of using domestic law and regulation to combat a problem that is by definition borderless. All would agree that for reasons of both maintaining a level playing field and encouraging comprehensive enforcement, international standards developed in cooperation among both the financial and criminal enforcement departments of all responsible governments, working together with industry groups, would be the ideal.

In the real world, however, political considerations and objective policy concerns have combined to produce a bipartisan consensus that, while international efforts need to be pursued, the United States must take what action it can now. The National Money Laundering Strategy for 2000 will not be delayed until the last quarter of the year (as was the case in 1999) and is expected to include affirmative legislative proposals. It is generally expected that legislation along the lines proposed by Chairman Leach in 1999 will be enacted soon, and international lawyers representing financial institutions engaged in international transactions, in particular private and correspondent banking activities, should begin to prepare for another escalation in the level of care and oversight that they and their clients will need to bring to international financial transactions.

II. United States: The Gramm-Leach-Bliley Act and International Banking

Among the most important legal developments for international banking in 1999 was the passage of the Gramm-Leach-Bliley Act (GLBA),[7] the new U.S. financial modernization legislation that finally repealed many of the old prohibitions on affiliations between banking and securities firms contained in the Glass-Steagall Act. This section focuses on the more significant impact of GLBA on international banking operations of both U.S. banking organizations operating outside the U.S. and non-U.S. banks operating within the United States.

A. Pre-GLBA Framework

The pre-GLBA legal framework effectively did the following: (1) limited U.S. bank holding companies (BHCs) to banking related activities in the United States (such as finance, leasing, financial data processing, securities underwriting, dealing, brokerage, and investment management services) and small, passive, noncontrolling investments (five percent voting equity, plus twenty percent nonvoting equity) in all U.S. companies; (2) generally applied the investment activities limitations applicable to BHCs to non-U.S. banks; (3) authorized non-U.S. banks to engage in certain financial activities in the United States provided such activities had an international component or connection; and (4) authorized non-U.S. banks to own through non-U.S. companies a commercial/industrial business in the United States, as long as the activity abroad (based on assets and revenues) were larger than the activities in the United States, unless the U.S. company owned by the non-U.S. companies was a subsidiary of the non-U.S. companies (twenty-five percent or otherwise control).[8] In this case, the U.S. company and non-U.S. company's activities had to be related to the activities engaged in directly or indirectly by the non-U.S. company abroad as measured by the SIC Code categories. Moreover, despite the intended separation of

7. Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1138 (1999).
8. Limits were imposed if the business was banking-related, securities-related, or financial in nature.

commerce, banking, and insurance under the pre-GLBA regime, *outside the United States*, a U.S. bank or BHC had broader powers to engage in securities underwriting, insurance underwriting, and commercial/industrial investments/activities. Therefore, in the United States, such U.S. banking organizations were limited to banking/financial activities on the grounds that the concentration of resources *in the United States* and the risks posed by unlimited securities underwriting, insurance underwriting activities, and commercial investments were unacceptable. Outside the United States, a different theory was applied to permit almost any banking, securities, insurance, or commercial investment activity on the grounds that (1) it would be necessary to compete with non-U.S. banks who had such powers abroad and (2) the amounts put at risk were limited.

B. The GLBA

1. *Generally*

The GLBA covers the following areas:

- Expands the financial activities permitted to BHCs;
- Establishes standards for qualifying as a Financial Holding Company (FHC) (well-capitalized and well-managed standards);
- Specifies standards applicable to non-U.S. banks as FHCs;
- Establishes new categories of financial activities permissible to FHCs, thereby allowing greater entry by securities firms, insurance underwriters, venture capital/private equity firms, and asset management firms in each other's market niche.

The GLBA expressly defines certain of these financial activities:

- Allows broader merchant banking activities;
- Establishes procedures for the Federal Reserve to define new financial activities;
- Establishes notification and approval procedures for engaging in new financial activities, and also streamlines the process for engaging in the activities or acquiring such companies;
- The GLBA grandfathered certain permitted activities for non-BHCs or non-U.S. banks that become FHCs;
- The GLBA establishes firewalls between depository institutions and affiliates in a financial conglomerate (an FHC), including limitations on transactions with affiliates;
- The GLBA expands the financial activities of national bank subsidiaries to activities that are financial in nature subject to firewalls, but generally prohibits insurance underwriting;
- The GLBA adopts functional regulation of banking, securities, and insurance industries, while leaving the Federal Reserve as the umbrella regulator to intervene for safety and soundness reasons, and to receive reports, conduct certain examinations under limited circumstances, impose capital adequacy guidelines on the FHC and generally not on the functionally regulated subsidiary, and limits the Federal Reserve's authority to regulate financial activities;
- The GLBA establishes consumer protection procedures for sale of insurance products through FHCs;

- The GLBA establishes the National Association of Registered Agents and Brokers;
- The GLBA narrows the definition of Bank Exempt Securities, so most bank conducted securities activities are required to be conducted by a broker-dealer by exempting such activities from the definition of broker and dealer, and investment adviser.

There are also several GLBA miscellaneous provisions that: (1) establish investment BHCs; (2) prohibit new unitary thrifts; (3) preempt state interference with expanding BHCs; (4) establish additional provisions affecting non-U.S. banks and their representative offices and interstate banking activities; (5) preserve the Community Reinvestment Act structure; (6) establish new guidelines on privacy, which could inhibit FHC cross-marketing activities, and which would apply to all "financial institutions" (broadly defined); and (7) regulate limited purpose banks, industrial banks, and credit card banks.

More specifically:

(i) An FHC generally does not require prior Federal Reserve approval to engage in, or acquire a non-bank company that engages in financial activities, such as a registered broker-dealer or investment adviser;

(ii) Although the GLBA eliminates the general exemption for a bank (including a branch or agency of a non-U.S. bank) from the definitions of "broker" and "dealer" currently contained in the Exchange Act, certain broker and dealer activities may continue to be conducted directly by a bank (including a branch or agency of a non-U.S. bank);

(iii) Bank affiliates may engage in "merchant banking activities" (as defined in the GLBA), subject to certain conditions;

(iv) Supervisory responsibilities of most personnel involved in securities activities will be transferred from the bank to registered broker-dealer affiliates, and such personnel will be required to satisfy the qualification requirements applicable to registered representatives of broker-dealers;

(v) A bank will become subject to the registration requirements of the Advisers Act to the extent that it acts as an investment adviser to a Registered Investment Company (RIC), and a bank-affiliated, registered broker-dealer may distribute shares of an RIC advised by an affiliated, registered investment adviser;

(vi) Bank-affiliated advisers will have significantly greater flexibility in structuring and operating investment funds that they manage;

(vii) GLBA narrows somewhat the exemption from registration for investment companies that are bank common trust funds;

(viii) GLBA places additional restrictions on affiliate transactions under the Company Act and adds two categories to the definition of "interested person" under the Company Act;

(ix) Limitations are placed on the sharing of customer information by financial institutions unless a form of "negative consent" procedure is followed.

2. *Non-U.S. Banks as FHCs*

Non-U.S. banks may file a declaration to be treated as an FHC if they meet the relevant criteria. The Federal Reserve is working on comparable capital and other operating standards for non-U.S. banks filing to be FHCs, giving due regard to national treatment and

equality of competitive opportunity.[9] The Federal Reserve is considering requiring non-U.S. banks to meet a leverage capital ratio (in addition to the risk-weighted ratio) in order to be considered well-capitalized (domestic BHCs are subject to a leverage ratio).

C. Equity Investment Options for Foreign Banks Under the GLBA

This subsection briefly discusses investment options available for BHCs and FHCs under the GLBA. There are two options (1 and 2 below) available to BHCs that are also non-U.S. banks, and three options (1, 2, and 3 below) that are available to FHCs in general.

1. *Implications for BHCs and Non-U.S. Banks*

If a banking organization chooses to become an FHC, it will have three investment options under the GLBA: (1) five percent to twenty-five percent investments as currently permitted under the Bank Holding Company Act of 1956 (BHCA);[10] (2) Regulation K investments as currently permitted under the BHCA and the International Banking Act of 1978 (IBA);[11] and (3) merchant banking opportunities under section 103(k)(4)(H) and section 103(k)(4)(I) of the GLBA—dealing with securities/investment adviser affiliates and dealing with insurance underwriters.

Since bank organizations will have these three alternatives, it is unclear how the Federal Reserve will interpret some of the merchant banking provisions including: (1) the term securities affiliate; (2) the divestiture period; (3) the phrase routinely operate/manage the company; (4) as necessary, etc. It is prudent for banking organizations at this stage to protect themselves with exit provisions that allow it to do more than simply reduce its voting investment to 4.9 percent. Indeed, because of the possible restrictions that the Federal Reserve could impose on merchant banking investments, a banking organization might find it desirable—under certain circumstances—to rely on the other regulatory authorities. It should be noted, however, that the other regulatory authorities (particularly Regulation K)[12] could be revised to conform to the policy behind the merchant banking provisions, and perhaps to create a more level playing field between non-U.S. banks and U.S. banks, since, as has always been the case, non-U.S. banks have advantages over U.S. banks in making investments in commercial companies.

There currently exist under Regulation K two options for investing by a non-U.S. bank: (1) those investment limitations that apply to U.S. banks outside the United States (which are more flexible than the investment powers permitted for U.S. banks within the United States),[13] and (2) the investment powers under Regulation K, section 211.23(f)(3) for non-U.S. banks (which, if they do not meet certain conditions, must meet the fifty percent asset/revenue test). For this reason, a banking organization needs flexibility. In order to do that, a banking organization needs to be able to monitor what investments are made by its

9. This contrasts to the requirements for a domestic BHC to become an FHC in that, domestically, capital/managerial standards are only applied to subsidiary banks. Further, the Board could use current comparable capital/managerial standards as a model or adopt new standards. The CRA criterion also does not appear to apply to a non-U.S. bank desiring to become an FHC, unless such a non-U.S. bank is a BHC by virtue of ownership of a U.S. bank or, possibly, has an insured branch.

10. Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-50 (1994).

11. International Banking Act of 1978, 12 U.S.C. § 3101 (1994).

12. 12 C.F.R. § 211 (1998).

13. Which a foreign bank may rely on as well just like any U.S. banking organization, and where limits of twenty percent, forty percent, and other conditions apply.

funds and portfolio companies, and thereby determine whether a "regulatory remedy" is necessary. It is usual for such regulatory remedies to be taken by banking organizations in venture capital/private equity investments, with the understanding that they would not adversely affect the funds or the other investors.

Moreover, the GLBA imposes firewalls on cross-marketing between a depository institution and affiliates, which includes a merchant banking investment fifteen percent owned by the FHC.

2. *Investment Option One—Five to Twenty-Five Percent Investments*

The GLBA amends the BHCA to create a new type of BHCs, the FHC, which is permitted to engage in all activities permitted to a BHC, as well as securities, insurance, and merchant banking activities that were prohibited to a BHC. In other words, an FHC may engage in expanded financial activities (such as securities, insurance, and merchant banking) and, at the same time, preserve all equity investment powers currently permitted to a BHC.[14] This is because an FHC is also a BHC and the fact that a BHC qualifies and elects to become an FHC extends, rather than limits, the scope of activities permitted to a BHC under the BHCA. A BHC that does not qualify or choose to become an FHC will be limited in its activities to those the Federal Reserve Board (the Board) had as of November 11, 1999 (the day before the enactment of the GLBA) deemed by regulation or order to be "closely related" to "proper incident" to banking.[15] In either case, a BHC or an FHC will continue to be able to invest up to five percent of the total outstanding voting securities and up to twenty-five percent of the total equity of a company without "controlling" the company under current law.

3. *Investment Option Two—Regulation K Investment*

Similarly, an FHC's Regulation K investment authority, as currently permitted under the BHCA and the IBA, remains unaffected by the GLBA for the same foregoing reason.[16]

14. Section 103 of the GLBA creates the FHC as a new entity and enumerates the expanded financial activities in which an FHC may engage. Section 103 was appended to section 4 of the BHCA as an amendment. Thus, it is clear that the GLBA was intended to add to the permissible activities of qualified BHCs.

15. *See* Pub. L. No. 106-102, § 102, 113 Stat. at 1341. Activity Restrictions Applicable to Bank Holding Companies That Are Not Financial Holding Companies; (a) in General—section 4(c)(8) of the Bank Holding Company Act of 1956 is amended to read as follows:

> (8) shares of any company the activities of which had been determined by the Board by regulation or order under this paragraph as of the day before the date of the enactment of the Gramm-Leach-Bliley Act, to be so closely related to banking as to be a proper incident thereto (subject to such terms and conditions contained in such regulation or order, unless modified by the Board).

12 U.S.C. § 1843(c)(8).

16. *See* 12 C.F.R. § 211.23(f). The only caveat is that a non-U.S. bank that becomes an FHC will lose any grandfather rights it had under the IBA to engage in activities that are permitted to an FHC. Section 141. Foreign Banks That Are Financial Holding Companies.

> Section 8(c) of the International Banking Act of 1978 (12 U.S.C. § 3106(c)) is amended by adding at the end the following new paragraph: (3) Termination of Grandfathered Rights. (A) in General—If any foreign bank or foreign company files a declaration under section 4(l)(1)(C) of the Bank Holding Company Act of 1956, any authority conferred by this subsection on any foreign bank or company to engage in any activity that the Board has determined to be permissible for financial holding companies under section 4(k) of such Act shall terminate immediately. (B) RESTRICTIONS AND REQUIREMENTS AUTHORIZED—If a foreign bank or company that engages, directly or through an affiliate pursuant to paragraph (1), in an activity that the Board has determined to be permissible for financial

However, the GLBA does not limit a non-U.S. bank's ability to utilize the exemptions under section 2(h)(2) or 4(c)(9) of the BHCA to engage in certain activities in the United States through companies it owns outside of the United States.[17] The Board may, after two years, require a non-U.S. bank that does not become an FHC and whose grandfathered subsidiary engages in financial activities permitted to an FHC, to conduct such activities subject to the same limitations imposed by the Board on FHCs conducting such activities (with due regard for national treatment and equality of competitive opportunity), including any prudential limitations.

4. *Investment Option Three—Merchant Banking*

The merchant banking provisions of the GLBA enable an FHC to make equity investments in portfolio companies, regardless of whether such investments constitute control, subject to certain conditions. Two provisions of the GLBA provide for merchant banking activities either by certain securities or insurance. Section 103(k)(4)(H) provides that an FHC may engage in merchant banking as a financial activity subject to the following restrictions: (i) such (the portfolio company's) shares, assets, or ownership interests are acquired and held by (A) a securities affiliate or an affiliate thereof or (B) an affiliate of an insurance company described in subparagraph (I)(ii)[18] that provides investment advice to an insurance company and is registered pursuant to the Investment Advisers Act of 1940, or an affiliate of such investment adviser; as part of bona fide underwriting or merchant or investment banking activities, including activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment; (ii) the shares, assets, or ownership interests are not acquired or held by a depository institution or a subsidiary thereof; (iii) the holding of any shares, assets, or ownership interests (such as an investment in a portfolio company by a private equity fund) may be for a period of time to enable disposition on a reasonable basis consistent with the financial viability of the activities described above; and (iv) during the period such shares, assets, or ownership interests are held, the FHC does not routinely manage or operate such company except as necessary or required to obtain a reasonable return on investment.[19]

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holding companies under section 4(k) of the Bank Holding Company Act of 1956 has not filed a declaration with the Board of its status as a financial holding company under such section by the end of the 2-year period beginning on the date of the enactment of the [Gramm-Leach-Bliley Act], the Board, giving due regard to the principle of national treatment and equality of competitive opportunity, may impose such restrictions and requirements on the conduct of such activities by such foreign bank or company as are comparable to those imposed on a financial holding company organized under the laws of the United States, including a requirement to conduct such activities in compliance with any prudential safeguards established under section [114 of the Gramm-Leach-Bliley Act].

17. In light of the GLBA, the Board will need to consider appropriate changes to the definition of "qualifying foreign banking organization" under Regulation K, such as to include all financial activities as "banking" for purposes of the definition. (Indeed, the Board's entire pending Regulation K proposal may need reworking.)

18. The insurance company must be predominately engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance), or providing and issuing annuities. The precise meaning of this restriction about the investment adviser affiliate of an insurance company is unclear. The legislative history of the GLBA revealed that this restriction was contained only in the Senate bill and not in the House bill, which required that merchant banking be conducted through an affiliate of the FHC that is a registered broker or dealer engaged in securities underwriting or another affiliate.

19. Section 103 of the GLBA amends section 4 of the BHCA to add activities that are financial in nature including:

(H) Directly or indirectly acquiring or controlling, whether as principal, on behalf of one or more

Section 103(k)(4)(I) of the GLBA permits an insurance company to engage in merchant banking provided that the shares, assets, or ownership interests of the portfolio company: (i) are not acquired or held by a depository institution or subsidiary of a depository institution; (ii) are acquired and held by an insurance company that is predominately engaged in underwriting life, accident and health or property and casualty (other than credit-related insurance) or providing and issuing annuities; (iii) must represent an investment made in the ordinary course of business of such insurance company in accordance with relevant state law governing such investments; and (iv) during the period such ownership interests are held, the FHC must not routinely manage or operate the portfolio company except as may be necessary or required to obtain a reasonable return on the investment.[20]

These provisions have given rise to many interpretive issues that the Federal Reserve and the Department of Treasury are expected to clarify with regulations. Among the issues are

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entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls), or otherwise, shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates, or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if

(i) the shares, assets or ownership interests are not acquired or held by a depository institution or subsidiary of a depository institution;

(ii) such shares, assets, or ownership interests are acquired and held by—

(a) a securities affiliate or an affiliate thereof; or

(b) an affiliate of an insurance company described in subparagraph (i);

(iii) that provides investment advice to an insurance company and is registered pursuant to the Investment Advisers Act of 1940, or an affiliate of such investment adviser;

as part of a bona fide underwriting or merchant or investment banking activity, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment;

(iv) such shares, assets, or ownership interests are held for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the activities described in clause (v); and

(v) during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.

20. Section 103 of the GLBA amends section 4 of the BHCA to add activities that are financial in nature including:

(I) Directly or indirectly acquiring or controlling, whether as principal, on behalf of one or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls) or otherwise, shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section of—

(i) the shares, assets, or ownership interests are not acquired or held by a depository institution or a subsidiary of a depository institution;

(ii) such shares, assets, or ownership interests are acquired and held by an insurance company that is predominately engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities;

(iii) such shares, assets, or ownership interests represent an investment made in the ordinary course of business of such insurance company in accordance with relevant State law governing such investments; and

(iv) during the period such shares, assets, or ownership interests are held, the bank holding company does not [routinely manage or operate such company except] as may be necessary [or required to obtain a reasonable return on investment].

queries relating to what constitutes a "securities affiliate" (broker only, or including an underwriter as well), the holding (divestiture) period of the portfolio company, what constitutes "routinely manage or operate," and when it becomes necessary to intervene in the management. The Federal Reserve is also considering whether to impose higher capital requirements for merchant banking and whether real estate is a permissible merchant banking activity. These difficult issues indicate that the actual scope of merchant banking activities is far from clear.

Other regulatory provisions (particularly Regulation K) could, however, be revised to conform (in some way) to the policy behind the merchant banking provisions, and perhaps to create a more level playing field between non-U.S. banks and U.S. banks, since non-U.S. banks have advantages over U.S. banks in making investments in commercial companies. Under Regulation K, there currently exist two options for investing by a non-U.S. bank: (1) those investments limitations that apply to U.S. banks outside the United States (which are more flexible than the investment powers permitted for U.S. banks within the United States) and (2) the investment powers under Regulation K, section 211.23(f)(3), for non-U.S. banks (which, if they do not meet certain conditions, must meet the fifty percent asset/revenue test). It is usual for such regulatory remedies to be taken by banking organizations that we represent in venture capital/private equity investments, with the understanding that they would not adversely affect the funds or the other investors.

D. Securities Activities

1. *Securities Activities*

The Federal Reserve has stated that a securities subsidiary/underwriter owned by a BHC (rather than an FHC—which meets certain capital, management, and Community Reinvestment Act standards) will be subject to revenue limitations and operating standards, very much like the current section 20 securities subsidiaries. The Federal Reserve believes that this distinction can be justified by the financial modernization legislation because institutions that do not qualify or choose not to qualify as FHCs may require as a policy matter "prudential limitations" in conducting their securities activities. This is not surprising since the twenty-five percent gross revenue limitation on ineligible revenues derived from underwriting equity and corporate debt securities was never written into the Glass-Steagall Act and never technically applied to non-U.S. banks with U.S.-member bank subsidiaries. Still, the Federal Reserve developed the idea of the revenue limitation and also imposed it on non-U.S. banks for competitive as well as prudential reasons.

2. *Non-U.S. Banks*

Currently under the IBA, non-U.S. banks that operate U.S. branches, agencies, or banks and that, as of 1978, offered a U.S. company (usually a securities underwriter), could continue to own such securities underwriters and engage in the same activities as conducted in 1978; such securities underwriters could not, however, expand through acquisition. Moreover, the Federal Reserve restricted the activities of such securities underwriters and their relationship with companies acquired by the non-U.S. banks. A non-U.S. bank that becomes an FHC will lose any grandfather rights it had under the IBA to engage in activities that are financial activities, but the GLBA does not limit a non-U.S. bank's ability to utilize the exemptions under sections 2(h)(2)[21] or 4(c)(9)[22] of the BHCA to engage in certain

21. Section 2(h)(2) reads:

Except as provided in paragraph (3), the prohibitions of section 4 of this Act shall not apply to shares

activities in the United States through companies it owns outside the United States.[23] The Federal Reserve may, after two years, require a non-U.S. bank that does not become an FHC and whose grandfathered subsidiary engaged in financial activities to conduct such activities subject to the same limitations imposed by the Federal Reserve on FHCs conducting such activities (with due regard for national treatment and equality of competitive opportunity), including any prudential limitations.

E. Foreign Banks: Standards to Become an FHC

1. *Who Must Meet the Standard?*

A foreign bank that operates a branch or agency, or controls a commercial lending company in the United States, and any company that controls such a foreign bank, will be eligible to become an FHC if the foreign bank is and remains well capitalized and well managed. The Rule states that a foreign bank that owns a subsidiary U.S. bank and that operates a U.S. branch or agency, or owns or controls a U.S. commercial lending company, must comply with the requirements applicable to FHCs to be an FHC, and must meet the standards for a foreign bank to be an FHC. A foreign bank that had a subsidiary U.S. bank, but no U.S. branch, agency, or commercial lending company, would only be required to meet the standards for a BHC to become an FHC. The Rule further states that a BHC that owns a foreign bank that operates a branch or agency or owns or controls a commercial lending company must comply with the standards for a BHC to be an FHC, while the foreign bank must comply with the standards for a foreign bank to be an FHC.

It is not clear from the Interim Rule how the Federal Reserve will view a foreign bank or holding company that owns one or more subsidiary foreign banks, where more than one of such foreign banks operates a U.S. branch or agency or owns a U.S. commercial lending company. For each foreign bank to itself engage in the expanded activities permitted to FHCs, it would appear that each foreign bank would have to meet the FHC standards. However, the Rule would also appear to permit the foreign bank in such a tiered organization that meets the standards to engage in expanded activities, even if a subsidiary or sister foreign bank subsidiary could not (e.g., the top tier foreign bank could own an insurance company, but the non-qualifying foreign bank could not).

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of any company organized under the laws of a foreign country (or to shares held by such company in any company engaged in the same general line of business as the investor company or in a business related to the business of the investor company) that is principally engaged in business outside the United States if such shares are held or acquired by a bank holding company organized under the laws of a foreign country that is principally engaged in the bank holding company organized under the laws of a foreign country that is principally engaged in the banking business outside the United States. For the purpose of this subsection, the term "section 2(h)(2) company" means any company whose shares are held pursuant to this paragraph.

22. Section 4(c)(9) reads:

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

23. In light of GLBA, the Board will need to consider appropriate changes to the definition of "qualifying foreign banking organization" under Regulation K, such as to include all financial activities as "banking" for purposes of the definition. (Indeed, the Board's entire Regulation K proposal may need reworking.)

It is not clear from the language of the Interim Rule how affiliated foreign banks with a U.S. branch will be treated. From the language of the Interim Rule, it is clear that for a foreign bank that has a U.S. branch to itself engage in financial activities it would have to meet the FHC standards. The Interim Rule also states that if a foreign bank is a BHC by virtue of owning a U.S. bank and also has a branch in the United States, the foreign bank can only be an FHC if the foreign bank meets both the standards required for a BHC and the requirements for a foreign bank. This Rule states that a BHC that owns a foreign bank that has a U.S. branch must comply with the domestic standards, while the foreign bank complies with the foreign bank standards. Note that a foreign bank that has only a U.S. subsidiary bank and no U.S. branch, would only have to meet the requirements for a BHC—that the subsidiary U.S. bank meets the FHC standards and the foreign bank would not have to. The Interim Rule does not explicitly state how a foreign bank that is not a BHC or owned by a BHC, but that has a subsidiary foreign bank with a branch in the United States will be treated. The foregoing provisions do, however, indicate that a foreign bank with both a bank and a branch, i.e., with more than one U.S. banking presence, must meet all requirements to be an FHC. It is not a far reach from this to say that a foreign bank with foreign bank subsidiaries, all of which have a branch, must also meet all rules for all entities with a U.S. banking presence.

The operative provisions of the Interim Rule state that "a foreign bank that operates . . ., and any company that owns or controls such foreign bank, will be treated as a financial holding company if . . . ." Again this language is unclear, but could be read to mean that the company and the foreign bank together are the FHC. On the other hand, the language does not explicitly state what happens when the "company" that controls the foreign bank is itself a foreign bank. Further, since the Interim Rule speaks in terms of "a" foreign bank, one could read this language to mean that as long as one foreign bank in a tiered organization met the standards, that foreign bank would file as an FHC even if the entire organization could not. This reading is based solely on the language of the Interim Rule and does not account for how as a policy or factual matter one could say that the entire organization does not benefit from the designation.

The staff of the Federal Reserve Board responsible for the foreign bank portion of the Interim Rule has indicated how they would treat "tiered" organizations (i.e., a holding company that owns more than one foreign bank with a U.S. branch, or a foreign bank with a U.S. branch that owns another foreign bank with a U.S. branch). The response was that each foreign bank with a U.S. banking presence in a tiered organization would have to meet the FHC standards for the tiered organization to become an FHC (in other words, our argument that the top tier foreign bank in the group was the only one that needed to meet the standard for it to become an FHC was not correct).[24] Based on the foregoing, a tiered foreign banking organization can only become an FHC as a whole, and to do so,

24. This is similar as a policy matter to what is required of a BHC that owns more than one depository institution. The FHC standard is that *all* depository institution subsidiaries (even those held through intermediary holding companies or owned by another depository institution subsidiary) must meet the well capitalized and well managed standard and anyone not meeting such standards would jeopardize the FHC status. (A BHC that is not itself a depository institution does not technically have to meet any standards to be an FHC, although the Interim Rule says that the Federal Reserve will consider the FHC's condition.). The Federal Reserve's position seems to be that for a foreign banking organization to be an FHC, all of its U.S. banking operations must also meet the standards (whether conducted by a subsidiary U.S. bank or foreign bank).

each "foreign bank" with a U.S. branch within the tiered organization must meet the FHC standards.

2. *What is "Well Capitalized?"*

A foreign bank will be considered "well capitalized" if it meets one of two alternative tests. If the foreign bank's home country supervisor has adopted risk-based capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision (Basel Accord), then the foreign bank will qualify if: (i) it maintains a Tier 1 capital to total risk-based assets ratio of six percent and a total capital to total risk-based assets ratio of ten percent, as calculated under its home country standard; (ii) it maintains a Tier 1 capital to total assets leverage ratio of at least three percent; and (iii) the Federal Reserve determines that the foreign bank's capital is comparable to the capital required for a U.S. bank owned by an FHC.[25] Alternatively, a foreign bank may request that the Federal Reserve determine that the foreign bank's capital is otherwise comparable to the capital that would be required of a U.S. bank owned by an FHC.[26] The Rule states that the Federal Reserve will endeavor to make such determination within thirty days of receipt.

The Rule requests comment on the imposition of a three percent leverage test. The Federal Reserve recognizes that many countries do not impose a leverage ratio or similar requirement, but nonetheless believes that the imposition of a leverage ratio is appropriate in order to ensure that the capital standards applicable to foreign banks are comparable to those for domestic depository institutions. In addition, the Federal Reserve believes that imposing a three percent leverage ratio, rather than the five percent required for domestic depository institutions, is appropriate in recognition of the fact that foreign banks hold both banking and non-banking operations under the foreign bank, and because it is similar to what is required of domestic BHCs to be considered well capitalized under Regulation Y.

Application of a leverage test as part of the well-capitalized standard applied to international banks is not required by the language of the Act, and is inconsistent with the Federal Reserve's expressed commitment to the development of international risk-based capital standards—as embodied in the Basel Capital Accord—as the appropriate means for assessing the capital adequacy of internationally active banking organizations.

3. *What is "Well Managed?"*

A foreign bank will be considered "well managed" if: (i) each of the U.S. branches, agencies, and commercial lending subsidiaries of the foreign bank has received at least a satisfactory composite rating at its most recent assessment; (ii) the home country supervisor of the foreign bank considers the overall operations of the foreign bank to be satisfactory or better; and (iii) the Federal Reserve determines that the management of the foreign bank meets standards comparable to those required of a U.S. bank owned by an FHC.[27]

4. *General Considerations*

The Rule states that in determining whether a foreign bank is well capitalized and well managed in accordance with capital and managerial standards comparable to those applied

25. *See* 12 C.F.R. § 225.90 (1999).
26. *Id.* § 225.90(b)(2).
27. *See* 12 C.F.R. § 225.90(c) (1999).

to U.S. banks, the Federal Reserve may take into account the foreign bank's composition of capital, accounting standards, long-term debt ratings, reliance on government support to meet capital standards, the extent to which the foreign bank is subject to comprehensive consolidated supervision, and other factors that may affect the analysis of capital and management. The Federal Reserve will consult with the home country supervisor for the foreign bank as appropriate. The Federal Reserve expects that most foreign banks that elect to be treated as FHCs will be subject to comprehensive consolidated supervision. The Federal Reserve also states that it will give due regard to national treatment and equality of competitive opportunity.

An international bank seeking to be treated as an FHC is required to obtain the Federal Reserve Board's affirmative determination that the bank is both well capitalized and well managed. In contrast to this quasi-application process, domestic institutions have the benefit of a streamlined, self-certification process whereby their status as an FHC is automatically effective thirty-one days after filing their declaration, unless within that period the Board raises objections.

In applying the Act's "well managed" standard to international banks, the Rule creates a procedure requiring a bank's home country supervisor to inform the Federal Reserve whether it considers the overall operation of the bank to be satisfactory or better, something home country supervisors may be reluctant to do. The Rule also provides that the Federal Reserve will make its own affirmative determination that the management of the entire bank "meets standards comparable to those required of a U.S. bank owned by a financial holding company." Consequently, the Rule has the potential to expand the Federal Reserve's review beyond its current practices in connection with the strength-of-support assessments (SOSA).

5. *Representative Offices*

The GLBA would amend the definition of "representative office" under the IBA to be any office of a non-U.S. bank that is not a branch or agency (giving the Federal Reserve the authority to find that a subsidiary of a non-U.S. bank is acting as a "representative office" of a foreign bank).[28] The Federal Reserve has taken the position that a subsidiary may not be used to evade federal approval or examination requirements, and that if it became aware of any evasions, it could take action to regulate such subsidiary as a banking office. The GLBA amendment gives the Fed the statutory authority to do so. The Federal Reserve would also be permitted to examine U.S. affiliates of a non-U.S. bank whose only banking presence in the United States is a representative office.

6. *Interstate Banking*

A non-U.S. bank would be permitted, with the approval of the Federal Reserve (and either the OCC or the state banking agency), to upgrade an agency or a limited branch to a full service branch outside its home state if the establishment and operation of such branch is permitted by such state and the agency or branch was in operation in such state on the day before September 29, 1994, or has been in operation in such state for a period of time that meets the state's minimum age requirement for the interstate merger of banks.

28. *See* GLBA, Pub. L. No. 153, 113 Stat. at 1384.

G. Summary Observations

The above are only some of the changes in U.S. international banking practices effected by this historic legislation. Only with the passage of time, as regulations are promulgated and applied, and the industries involved take advantage of the new opportunities offered and react to new regulatory challenges, will we learn the full impact of this regulatory revolution on the international activities of U.S. banks, and the U.S. activities of banks from abroad.

III. Mexico: Year in Review 1999

The following is intended as a brief and selective chronological summary of some of the more significant developments in the banking law area in Mexico.

1. On January 18, 1999, with the purpose of creating an entity to protect and defend the general public in their transactions with financial entities, the Law for the Protection and Defense of Customers of Financial Entities Law *(Ley de Protección y Defensa al Usuario de los Servicios Financieros)* was published in the Official Gazette of the Federation. The law created the National Commission for the Protection and Defense of the Customers of Financial Entities (*Comisión Nacional para la Defensa de los Usuarios de Servicios Financieros*, the CONDUSEF). The two main purposes of this Commission are: (i) to regulate the surveillance and inspection of the information that financial entities must provide to their customers; and (ii) establish dispute resolution proceedings between financial entities and their customers.

   The CONDUSEF replaces the complaint units that formerly belonged to the National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*, the CNBV) and the National Commission of Insurance and Bonds (*Comisión Nacional de Seguros y Fianzas*, the CNSF).
2. On May 17, 1999, several provisions of the chapters regulating criminal activities of the Credit Institutions Law, the Securities Market Law and other financial laws, as well as the Federal Code for Criminal Procedures were amended. These amendments seek (i) to increase imprisonment penalties and fines; (ii) to establish responsibility through aggravating circumstances; (iii) to include as criminal offenses those actions that, although they were already deemed as crimes in other laws, did not have an adequate description, nor a penalty consistent with its seriousness; and (iv) to establish that directors of financial institutions may be subject to criminal liability, as well as all other persons that directly intervene and participate in a transaction that causes a distress or asset damages to any financial entity.

   Also, the aforementioned amendments establish (i) a term for the exercise of actions in connection with the commission of the crimes regulated in the financial laws, such term being three years as of the date of the knowledge of the crime, or five years as of the date in which the crime was committed, if there is no knowledge of same; (ii) that the prosecution of said crimes will be initiated not only at the request of the Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*, or SHCP), with the prior opinion of the CVNB and the CNSF, but also at the request of any interested third party; (iii) the creation of new criminal actions in respect to the activities performed by public officials of the CNBV and CNSF closely related to the crime of bribery; and (iv) that all individuals that perform financial activities reserved to financial entities without authorization will be sanctioned, as well as those

who having such authority do not comply with the corresponding regulations.

The Credit Institutions Law established new criminal sanctions for activities related to the production, reproduction, distribution, commercialization, introduction into the country, use, and possession of any payment instrument used by the banking system, either without the corresponding authorization or with the knowledge that such payment instrument is false.

3. On May 28, 1999, the Banking Savings Protection Institute (*Instituto de Protección al Ahorro Bancario*, the IPAB) began operations. The IPAB was created by the Savings Protection Law (*Ley de Protección al Ahorro Bancario)*, which was approved by Congress on December 11, 1998, and published in the Official Gazette of the Federation on January 19, 1999. The IPAB replaced the Banking Savings Protection Fund (*Fondo Bancario de Protección al Ahorro*, the FOBAPROA). The purpose of the IPAB is to insure Mexican bank deposits and provide financial assistance to distressed Mexican banks. On May 28, 1999, the IPAB began its operations as a decentralized organism controlled by the Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*, the SHCP).
4. On May 31, 1999, the newly created IPAB issued regulations regarding the ordinary fees that Mexican commercial banks must pay. On June 18, 1999, the IPAB issued the regulations regarding the program that replaces the Capitalization and Credit Purchase Program (*Programa de Capitalización y Compra de Cartera)*, which was formerly part of FOBAPROA.[29] These regulations establish that once the auditing process ordered by the Mexican Congress ends, banks that participated in the aforementioned program will be entitled to terminate the agreements and cancel the operations that they had with FOBAPROA. Consequently, such banks will return to fund the payment instruments issued on their behalf for their further cancellation. These provisions allow banks to enter into an agreement with the IPAB in order to participate in the new banking insurance projects. Through this program, a trust is created in which every bank will deliver the amounts and other assets and rights that it receives as a result of the administration, recovery, and collection of the credits. The IPAB will deliver to each bank in this program payment instruments that will replace the instruments issued by FOBAPROA. The instruments of the IPAB will maintain altogether the same accounting value at the date of the operation, term, payment of interests, yield rate, and capital amortization of the instruments issued by FOBAPROA.
5. On September 22, 1999, the SHCP issued the new Regulations for Capital Adequacy of Commercial Banks, as well as an amendment to the Credit Rating Regulations of Mexican Commercial Banks. These provisions are part of the actions taken by the financial authorities to support and strengthen the financial condition of Mexican banks. Likewise, the mentioned amendments seek to bring the Mexican financial system closer to international standards.

   (a) The main purposes of the new Capital Adequacy Regulations are: (i) to improve the capitalization of the Mexican banking system as a whole; (ii) to induce banks

29. Regla Generales del Nuevo Programa al Que se Refiere el Articulo Quinto Travisitorio de la ley de Proteccion al Ahorro Bancario (June 18, 1999), *available in* LEXIS, Mexico Library, Legislation, Leyes Federales file.

to improve their financial condition and solvency; (iii) to widen banks' possibilities of obtaining capital resources; (iv) to cause banks to maintain a capitalization level consistent with their risk levels; and (v) to insure banks' capitalization by the beginning of the year 2003, in which the reduction of the deposit insurance coverage will significantly impact the banks' liabilities.

The new Capital Adequacy Regulations establish, among other provisions, the following: (i) banks must deduct from their net capital the value of the shares that they acquire of non-financial companies; (ii) the convertible debentures will only be part of the bank's complementary capital; and (iii) new banking capitalization instruments are authorized to be issued, which have been commonly used by international financial institutions.

The Capital Adequacy Regulations for Commercial Banks became effective as of January 1, 2000, and provisions will gradually enter into force until the year 2003, when banks are expected to be fully capitalized.

(b) The Credit Rating Regulations, as amended, establish that: (i) the current fixed percentage of reserves will be eliminated through the incorporation of continued ranges between zero and 100 percent; (ii) the concept of general reserves is introduced as part of the bank's complementary capital ("general reserves" being defined as those created to support losses not identified to a particular credit); and (iii) the CNBV is authorized to issue regulations relating to the new credit rating methodology.

The aforementioned amendments became effective on the date of their publication in the Official Gazette of the Federation, on September 22, 1999, and they will gradually enter into force as the CNBV issues the respective methodology for the different types of credits.

IV. Canada's New Foreign Bank Entry Regime

It had been clear for some time that the Canadian government, in part due to pressure from the international trading partners of Canada, was prepared to ease certain restrictions on the activities of foreign banks in Canada. Under the previous foreign bank entry regime, subject to certain minor exceptions, foreign banks could only open a representative office in Canada or carry on a banking business in Canada through Canadian incorporated subsidiaries. Such foreign bank subsidiaries have a restricted asset base, are costly to run and, with few exceptions, have failed to obtain any significant share of the Canadian market.

Bill C-67, an Act to amend the Bank Act, the Winding-up and Restructuring Act and other Acts relating to financial institutions and to make consequential amendments to other Acts (the Act), introduced into the House of Commons on February 11, 1999, significantly improved how foreign banks can operate in Canada. The Act, subject to minor exceptions, came into force on June 28, 1999.[30] The main thrust of the Act is to permit foreign banks to establish direct branches in Canada rather than operate through subsidiaries, consequently improving their operational flexibility and lending ability as well as reducing the corporate governance requirements applicable to them.

30. Winding-Up and Restructuring Act, 5 R.S.C. ch. W-11, § 10.1 (May 24, 2000) (Can.), *available in* LEXIS, R.S.C. 1985, ch. W-11, § 10.1.

A. The Act

The Act amended the Bank Act by incorporating Part XII.1, which introduces the concept of "authorized foreign banks," without, however, eliminating those of representative office or foreign bank subsidiary. Authorized foreign banks are banks that are permitted to carry on a banking business but which are neither domestic Canadian banks (Schedule I banks) nor foreign bank subsidiaries (Schedule II banks). An authorized foreign bank has the option of establishing either a "full service" branch or a "lending branch." Such choice of branch type will be discussed below.

1. *Formalities of Authorization*

Under the new rules, a foreign bank is permitted to establish a branch in Canada and carry on a banking business if, among others, the Minister of Finance (the Minister) is satisfied,[31] after consultation with the Superintendent of Financial Institutions of Canada (the Superintendent), in respect of items (iii) and (iv) below, that:

(i) the authorized foreign bank will be capable of making a contribution to the financial system in Canada;
(ii) reciprocal treatment will be provided for Canadian banks in the principal jurisdiction in which the authorized foreign bank carries on business;
(iii) the applicant is a bank and is regulated in a manner acceptable to the Superintendent; and
(iv) the applicant's principal activity is the provision of services, which the Bank Act permits a bank to provide in Canada.

Major international banks should not have serious problems satisfying the Minister on these points. The Minister is, however, authorized to take all relevant factors into account in considering the application,[32] including the following:

(i) the nature and sufficiency of the financial resources of the foreign bank as a source of continuing financial support for the carrying on of its business in Canada;
(ii) the soundness and feasibility of the plans of the foreign bank for the future conduct and development of its business in Canada;
(iii) the business record and past performance of the foreign bank;
(iv) whether the business in Canada of the proposed authorized foreign bank will be carried on responsibly by persons who are fit as to the character, competence, and experience suitable for involvement in its operations; and
(v) the best interests of the financial system in Canada.

In addition, the applicant foreign bank will be expected to:[33]

(i) prove that its risk-based capital ratio meets the capital adequacy requirements of the Office of the Superintendent of Financial Institutions (OSFI);
(ii) prove that it is of sufficient size, experience and financial health to support its Canadian operations:

- have a minimum consolidated asset base of Cdn.$5 billion, in the case of a "full service" branch application only;
- possess a proven track record in international banking;

31. Bank Act, S.C. 1991, c. 46, § 524 (2000) (Can.).
32. *See id.* § 526.
33. *See* Guide to Foreign Bank Branching issued by OSFI, § 4.0.

- demonstrate a favorable financial performance over the last five years; and
- in most cases, have a controlling parent that is widely held in its home jurisdiction;

(iii) have a five-year business plan setting out the branch's proposed business in Canada;

(iv) undertake to keep OSFI informed of significant developments that could adversely affect the applicant's soundness and reputation globally and provide copies of important media releases (with translation where appropriate) and, as required, financial accounts.

2. *Commencement and Carrying on of Business in Canada*

An authorized foreign bank may not commence to carry on business in Canada until it is authorized to do so by an order made by the Superintendent to that effect.[34] The Superintendent may make the order only if he is satisfied[35] that the authorized foreign bank has:

(i) deposited in Canada unencumbered assets of a type approved by the Superintendent, the total value of which shall be:
- in the case of a "lending" branch, Cdn.$100,000;
- or, in any other case, Cdn.$10,000,000, or any greater amount that the Superintendent specifies, which assets must be kept with a Canadian financial institution approved by the Superintendent pursuant to a deposit agreement entered into with the prior approval of the Superintendent;

(ii) submitted a power of attorney provided to the principal officer of the authorized foreign bank and expressly authorizing such principal officer (who must be a Canadian resident)[36] to receive all notices under the laws of Canada from the Minister or the Superintendent;[37] and

(iii) complied with all other relevant requirements of the Bank Act.

3. *Choice of Branch Type*

As mentioned above, an authorized foreign bank has the option of establishing either a "full service" branch or a "lending" branch. A "full service" branch will not be entitled to accept deposits[38] or act as an agent in the taking of deposits[39] of less than Cdn.$150,000, which are payable in Canada. A "lending" branch will not be entitled to: (i) accept deposits at all except from Canadian financial institutions and certain foreign banks, or to (ii) act as agent for any person taking deposit liabilities, and will be limited in its ability to guarantee traded securities and bills of exchange.[40] On an ongoing basis, the "lending" branch will have to maintain on deposit only Cdn.$100,000, while the "full service" branch will have to continue to maintain the greater of Cdn.$10,000,000 and an amount equal to five percent

34. *See* Bank Act, S.C. 1991, c. 46, § 534 (2).
35. *See id.* § 534(3).
36. *See id.* § 536(1).
37. *See id.* § 536(2).
38. *See id.* § 545.
39. *See id.* § 546.
40. *See id.* § 540.
41. *See id.* § 582.

of its liabilities in respect of its business in Canada.[41] Generally, a "lending" branch will also be subject to less frequent examination by the Superintendent.[42]

4. *Business and Powers*

These differences aside, the "lending" branch and the "full service" branch operate in much the same manner. Subject to the restrictions noted above, an authorized foreign bank is only entitled to carry on the business of banking and any business generally that pertains to the business of banking in Canada,[43] such as, for instance, the lending of money, credit and treasury functions, derivatives, and private client wealth management. This also specifically includes financial services, investment counseling services, portfolio management services, issuing credit cards, and operating credit card plans.[44] In addition, an authorized foreign bank may also exercise other activities, including the holding and management of real property, acting as a custodian of property, and acting as a receiver, liquidator, or sequestrator.[45] Lastly, a "full service" branch may, in respect of its business in Canada, guarantee traded securities and bills of exchange.[46]

5. *Operating Restrictions*

There are, however, some restrictions on what activities the authorized foreign bank will be allowed to engage in. For example, an authorized foreign bank will not be able to provide fiduciary services,[47] grant security interests on its assets,[48] or be a general partner in a limited partnership or a partner in a general partnership,[49] and will be subject to restrictions on tied selling.[50] Furthermore, the ability of an authorized foreign bank to deal in securities[51] or undertake the business of insurance[52] is restricted in much the same way as are domestic Canadian banks and foreign bank subsidiaries. The federal government decided not to give authorized foreign banks powers not presently enjoyed by Canadian domestic banks. The authorized foreign bank is also subject to all the normal rules with respect to the opening of deposit accounts (in the case of the "full service" branch only),[53] the disclosure of borrowing costs,[54] auditing,[55] and recordkeeping.[56] Thus, subject to the above comments on deposits, an authorized foreign bank fundamentally has the same powers as a domestic Canadian bank.

6. *Investment Restrictions*

From the point of view of a foreign bank structuring its operations in Canada, an authorized foreign bank is also restricted in its investment activities in Canada (except for

42. *See id.* § 613.
43. *See id.* § 538(1).
44. *See id.* § 538(2).
45. *See id.* § 539.
46. *See id.* § 541(1).
47. *See id.* § 544.
48. *See id.* § 552.
49. *See id.* § 553(1).
50. *See id.* § 576(1).
51. *See id.* § 548; Securities Dealing Restrictions (Authorized Foreign Banks) Regulations, Can. Reg. Con. SOR/99-275 (1999).
52. *See* Bank Act, S.C. 1991, c. 46, § 549; Insurance Business (Authorized Foreign Banks) Regulations, Can. Reg. Con. SOR/99-279 (1999).
53. Bank Act, S.C. 1991, c. 46, §§ 541(2), 559-66.
54. *See id.* §§ 567-74.
55. *See id.* §§ 584-96.
56. *See id.* §§ 597-98.

those activities that may be temporarily "grandfathered" at the time it obtains approval to commence business).[57] Like a domestic Canadian bank, it is prohibited from acquiring more than ten percent of companies that would fall outside of the generic term of "financial sector companies." However, a "full service" branch will be permitted to acquire up to 100 percent of the shares of any Canadian entity if such entity is a foreign bank subsidiary, a financial institution (including a loan and trust company, an insurance company, or a securities firm), or various other companies that domestic Canadian Banks and foreign bank subsidiaries are permitted to acquire, such as factoring corporations, financial leasing corporations, or real estate holding corporations.[58] This means that an authorized foreign bank is readily able to operate through both a branch and a foreign bank subsidiary. A "lending" branch will be more limited in that it will be prohibited from acquiring control of, or a substantial investment in, an entity that is authorized to accept deposits such as a trust company.[59]

B. New Taxation Rules

Proposed amendments to the Income Tax Act, accompanying the Act, aim to put branches of foreign banks and Canadian foreign bank subsidiaries operating in Canada in a tax position comparable to that of Canadian domestic banks. Such changes, which essentially deal with branch interest expense, nonresident withholding tax, thin capitalization rules, capital tax, branch tax, foreign tax credits, and tax deferred conversion of a foreign bank subsidiary to a branch, while not enacted into law as of February 29, 2000, are expected to be effective retroactively to June 28, 1999, that being the date the new foreign bank branching legislation came into effect.

The most significant proposed tax amendment, from a commercial lending perspective, deals with nonresident withholding tax. Under Part XIII of the Income Tax Act, withholding tax is levied on interest paid by a resident of Canada to a nonresident (subject to certain exceptions). Under the proposed amendments, an authorized foreign bank will be deemed a person resident in Canada with respect to interest paid directly to it. Thus, a Canadian resident paying interest on loans to a foreign bank branch will not have to withhold tax. This change will also help ensure that foreign branches will be able to compete with domestic Canadian banks in various lending transactions.

C. In Summary

The development of the licencing regime for authorized foreign banks, while consistent with what is happening in other international marketplaces, constitutes a substantial change to the regulation of foreign banks in Canada. Entry by financial institutions should be less costly, the lending branch will be able to be established with minimal Canadian capital adequacy requirements, branches will be able to take advantage of the capital base of the banking group as a whole, and the cost of business through a Canadian branch for multinational clients should be reduced. The changes are clearly not designed, however, for those financial institutions wishing to enter the retail deposit business. Traditionally, however, in the Canadian market, foreign financial institutions have primarily targeted institutional business.

57. *See id.* § 529.
58. *See id.* § 518(1.1).
59. *See id.* § 518(1.2).