by the foreign banking organization at such offices have received at least a "satisfactory" composite examination rating from the U.S. banking supervisors; and (iii) the overall rating of the foreign banking organization's combined U.S. operations is at least "satisfactory." Further, no branch, agency, or depository institution may have received one of the two lowest composite ratings at its most recent examination. In addition, as with domestic bank holding companies, no U.S. branch, agency or insured depository institution may be subject to an asset maintenance agreement with its chartering or licensing authority.

The Federal Reserve may disqualify any banking organization, including a foreign banking organization, from using the streamlined procedure for any appropriate reason, including if information from the primary supervisor of a domestic bank or home country supervisor for a foreign bank indicates that a more in-depth review of proposals involving that organization is warranted.

Tying restrictions. In addition, the Regulation Y revision provides a "safe harbor" to the anti-tying rules created by section 106 of the Bank Holding Company Act Amendments of 1970. The revision created a safe harbor for transactions with corporate customers that are incorporated or otherwise organized, and have their principal place of business, outside the United States, or with individuals who are citizens of a foreign country and are not resident in the United States. Recognizing that U.S. legislation generally is presumed to apply only within the territorial jurisdiction of the United States, the safe harbor is intended to provide certainty for the applicability of the anti-tying rules to a defined set of transactions.

Proposed Revision of Regulation K

In December 1997, the Federal Reserve issued for public comment its proposed revision to Regulation K governing, among other things, the U.S. operations of foreign banking organizations. The FRB's proposed revisions to Regulation K would affect the U.S. nonbanking activities of certain qualifying FBOs, and the interstate banking operations of foreign banks in the United States.

QFBO activities. The FRB's proposed regulations include certain revisions to the qualifying foreign banking organization (QFBO) standard, and the permissible activities of QFBOs. Status as a QFBO is required in order for a foreign banking organization to take advantage of certain exemptions to the nonbanking restrictions contained in section 4 of the Bank Holding Company Act. In order to qualify as a QFBO, a foreign banking organization must demonstrate that: (i) more than half of its business is banking; and (ii) more than half of its banking business is conducted outside the United States. Banking business is defined to include the activities permissible for a U.S. banking organization to conduct, directly or indirectly, outside of the United States.

Under the current regulation, such activities must be conducted in the foreign bank itself or in the foreign bank's subsidiaries in order to be counted as part of the foreign bank's banking business for purposes of meeting the QFBO test. The FRB's proposed revision would permit:

- financial activities conducted by a foreign bank's holding company or sister affiliates to be counted toward the first prong of the QFBO test (that more than half of the foreign banking organization's activities be "banking"); and

- a QFBO indirectly to hold up to 10 percent (up from the current 5 percent) of the shares of a U.S. company that underwrites, sells or distributes securities in the United States in a manner that is impermissible for U.S. bank holding companies.

In addition, the FRB requested public comment on whether the list of activities that would be considered "banking" for purposes of the QFBO test should be expanded beyond the activities permissible for a U.S. banking organization abroad.

Limitations on nonbanking subsidiaries of QFBOs. The FRB also requested comment on whether it should prohibit a QFBO from using its U.S. nonbanking companies held pursuant to section 4(c)(8) of the Bank Holding Company Act to hold the shares of foreign subsidiaries that engage in activities that are impermissible for U.S. banking organizations. Regulation K currently exempts a QFBO from the nonbanking restrictions contained in section 4 of the BHC Act for any activity conducted by the QFBO outside the United States. The FRB noted that some QFBOs have interpreted the general exemption in Regulation K for non-U.S. activities as extending to the foreign subsidiaries of section 4(c)(8) subsidiaries. The FRB stated that the exemption was not intended to allow U.S. companies owned by QFBOs under section 4(c)(8) to engage in unrestricted foreign activities.

Interstate operations under the Riegle-Neal Act. The FRB's proposal also includes revisions to reflect changes to the authority of U.S. and foreign banking organizations to conduct interstate banking operations contained in the Riegle-Neal Act. The revisions basically link the ability of foreign banks to operate on an interstate basis to the ability of a U.S. bank or bank holding company with the same home state to do so. This framework is intended to advance the policy of providing national treatment to foreign banks with respect to their U.S. operations. The revisions provide for:

- a new procedure whereby a foreign bank could change its home state an unlimited number of times if it can show that a domestic bank with the same home state would be able to change its home state in a similar manner;

- upon a change in home state, retention by a foreign bank of any existing interstate branches if the foreign bank could establish such branches from its new home state under current law; and

- deletion of the home state "attribution rule," which provides that a foreign bank (or other company) and all other foreign banks which it controls must have the same home state.

Streamlined procedures for establishing U.S. offices in certain situations. The FRB's proposal also contains provisions for streamlining the approval process for additional U.S. banking offices of a foreign bank under certain circumstances. As discussed above, the Foreign Bank Supervision Enhancement Act (FBSEA) generally requires the FRB to determine that a foreign bank is subject to CCS by its home country supervisor before approving an application by that foreign bank to establish a branch or agency office in the United States. Under the FRB's proposed revisions, the general requirement for a CCS determination is retained, but foreign banks that have been approved previously by the FRB for a U.S. office under FBSEA, or are subject to FRB supervision under the BHC Act, would be permitted to establish additional U.S. direct offices under prior notice or general consent procedures, depending on the nature of the foreign bank applicant's previous FRB approvals, and the type of additional office desired. The proposed streamlined procedures provide for:

- establishment of additional U.S. branches, agencies, commercial lending company subsidiaries, and representative offices pursuant to a 45-day prior notice procedure by any foreign bank that the FRB has determined to be subject to CCS in a prior application under FBSEA;

- establishment of a representative office pursuant to a 45-day prior notice by any foreign bank that the FRB had previously approved to establish a representative office, or is subject to the BHC Act;

- general consent for the establishment of a representative office by a foreign bank that is both subject to the BHC Act, and previously has been determined by the FRB to be subject to CCS; and

- general consent for the establishment of a regional administrative office by any foreign bank that is subject to the BHC Act.

The proposed revision would also amend Regulation K to reflect the FRB's discretion to approve a branch or agency application without a determination that the foreign bank is currently subject to CCS, if the FRB finds that appropriate authorities in the applicant's home country are "actively working to establish arrangements for the consolidated supervision" of the applicant. The regulatory revision makes it clear that, in approving an application under this authority, the FRB may impose any conditions or restrictions relating to the activities or business operations of the proposed office or subsidiary, including restrictions on sources of funding.

Revision of All OCC Regulations, Including International Banking Activities Regulation

In May 1996, the OCC revised its regulations relating to international banking activities, now found in Part 28. Revised Part 28 reduces burden by removing the requirement for the two separate filings that national banks formerly had to make when they establish a foreign branch or acquire certain

foreign investments. It permits national banks simply to provide notice of these transactions. This notice requirement may be satisfied by providing the OCC with a copy of the filing made with the FRB. Under the new regulation, the OCC accepts a copy of an application form, notice, or report submitted by a foreign bank or a federal branch or agency to another federal regulatory agency that covers the proposed action and contains substantially the same information that would be required by the OCC. Revised Part 28 also consolidates the substantive requirements governing international banking operations supervised by the OCC into a single, comprehensive regulation.

The OCC also revised Part 5, Rules, Policies, and Procedures for Corporate Activities, which applies to federal branches and agencies. The final rule comprehensively revises and streamlines the OCC's rules, policies, and approval process for applications and corporate filings. It also substantially revises the OCC's operating subsidiary rules, providing different levels of review and treatment for operating subsidiary applications depending on the novelty and complexity of the activities to be undertaken. The final rule establishes a procedure that national banks can use to request approval for an operating subsidiary to engage in activities that would not be permissible for the bank to conduct directly. This latter type of application is subject to a public notice and comment process, and the OCC will approve such an application only under certain, well defined conditions. The OCC has issued 22 booklets updating the Comptroller's Corporate Manual to provide more specific guidance on Part 5 and other revised regulations.

Finally, the OCC revised other significant regulations that, like Part 5, apply to federal branches and agencies as well as national banks because a federal branch or agency generally conducts its operations subject to the same authority and limitations as a national bank. The final revision to Part 7, Interpretive Rulings, modernizes and clarifies interpretive rulings in a variety of areas, including electronic money and banking, corporate governance, and the definition of "interest" for purposes of 12 U.S.C. § 85. The OCC's revision of Part 1, Investment Securities, updates the OCC's regulations to reflect certain statutory changes and codifies important OCC interpretive positions with respect to the permissibility of asset securitization and indirect investment in assets in which a national bank may invest directly. The final revision to Part 9, Fiduciary Activities, comprehensively revises the OCC's fiduciary activities regulation. The new regulation includes revisions to the rules on collective investment funds and modernizes the OCC's rules to reflect the significant changes that have taken place in the way national banks conduct these lines of business.

Reductions in Assessment Fees on National Banks and Federal Branches and Agencies

The OCC has modified its assessment regulation, Part 8, in a manner that reduced the assessment fees of foreign banks with more than one federal branch or agency. Certain federal branches and agencies are now eligible for the reduction in assessments that is available for "non-lead" national banks that are part of a holding company. If a foreign bank has more than one federal branch or agency, the largest branch will pay the full assessment, and the other branches will have their assessment reduced by 12 percent.

Reduction in Regulatory Burden on Federal Branches and Agencies

The OCC has modified its supervision of federal branches and agencies to reduce the regulatory burden by increasing focus on the foreign bank as a whole and decreasing focus on the federal branch or agency as a stand-alone operation. These changes are consistent with the OCC's supervision of national banks, which emphasizes risk management in the banking organization as a whole. Specifically, the revised policies provide that:

- The OCC discontinued its policy of requiring a branch-specific allowance for loan and lease losses (ALLL) or that the parent bank management acknowledge that an ALLL for federal branch assets is being maintained on a consolidated basis. Instead, to aid examiners in assessing the adequacy of the credit risk management processes, federal branches and agencies must be able to demonstrate the maintenance of an effective loan review system and controls in conformity with current OCC policy on the ALLL;

- The OCC eliminated the 10 percent of assets threshold currently used to identify concentrations of assets at federal branches and agencies, and examiners will instead assess the adequacy of systems and procedures at a federal branch or agency that enable the head office to monitor and evaluate asset concentrations;

- The OCC eliminated the requirement that federal branches and agencies with a Net Due From Head Office position in excess of 50 percent of assets work to reduce this position. Instead, examiners will review the adequacy of Net Due To/From Head Office positions on a case-by-case basis as part of the assessment of the parent company's strategies for funding the federal branch or agency and the overall liquidity position of the branch.

Additional Activities Permissible for National Banks or Federal Branches and Agencies

The OCC has determined that a number of additional activities or investments are permissible for national banks or federal branches and agencies. Federal branches and agencies generally may conduct the same activities, subject to the same restrictions, as national banks. Some recent OCC decisions include the following:

- A federal branch may enter into net leases of real estate to serve the home finance needs of its Muslim customers, who are prohibited by religious principles from obtaining traditional mortgages. The net leases are structured so that all of the indicia of ownership pass to the lessee and the leases meet secular accounting standards for being classified as financing transactions.

- Full participation in a multilateral clearing organization is allowed for foreign banks with federal branches and agencies. Netting and collateral agreements of the multilateral clearing

organization are enforceable against participants that are uninsured federal branches or agencies in the event the OCC appoints a receiver for the federal branch or agency.

- A national bank may offer time deposits to its customers in approximately 20 different foreign currencies through the Internet and through traditional means.

- The U.S. Supreme Court upheld the OCC's determination that the National Bank Act preempts state law prohibiting most banks from selling insurance as agent. The OCC subsequently decided that a national bank's insurance agency is permitted the same marketing range and same marketing tools and facilities as are generally available for licensed insurance agencies in the state where the bank agency operates.

- A national bank may act as a finder for customers and insurance agents and split commissions with the insurance agent, but must comply with applicable state insurance laws.

- Despite state laws prohibiting banks from selling annuities, a national bank may sell as agent variable-rate as well as fixed-rate annuities, which the OCC regards as financial investments rather than insurance under the National Bank Act.

- A national bank subsidiary may underwrite and reinsure credit disability and involuntary unemployment insurance in connection with credit card loans made by the bank's affiliated credit card bank.

- In addition, a national bank may underwrite safe deposit box liability insurance for the bank and its affiliates.

- It is permissible for a national bank subsidiary to enter into reinsurance agreements with a number of unaffiliated insurance carriers that issue mortgage insurance on mortgage loans originated or purchased by the bank or its affiliates. A national bank may establish a reinsurance subsidiary that reinsures private mortgage insurance on loans originated, purchased, or serviced by a bank and its affiliates.

- A national bank operating subsidiary may, subject to special conditions, underwrite, deal and invest in municipal revenue bonds.

- A national bank may exchange portions of its portfolio of Brazilian, Mexican, and other Latin American countries' sovereign debt (held in the form of Brady bonds) for minority interests in unaffiliated investment companies formed to invest in Brazil, Mexico, and Latin America, respectively.

- A national bank subsidiary may act as a certification authority and repository for electronic "certificates" used to verify digital signatures.

- National banks, through minority investments in a limited liability company, may operate an electronic network and gateway to support home banking operations of the investing banks and other banks. A national bank may provide home banking services by means of a direct and Internet connection to the bank's home banking system.

- A national bank may make a minority investment in a company providing electronic funds transfer and electronic data interchange in a worldwide electronic commerce network.

- As part of the business of banking, a national bank may purchase a minority interest in a limited liability company engaged in the development, distribution, and maintenance of computer software for cash management applications.

- In the context of correspondent banking services, a national bank, through an operating subsidiary, may provide computer network services and related full function hardware to other financial institutions.

- National banks may invest in a company that would issue electronic stored value in an open or widely dispersed system and provide support services for the stored value system and invest in a company that would develop, install, and support "closed" stored value systems based on smart card technology.

- A national bank can acquire and lease real property provided the real estate lease transaction is incidental to a permissible lease financing of personal property.

In addition, following consultation with the State of New York and FRB, the OCC determined that a foreign bank's federal branch in the United States would be permitted to operate through a loan production office in New York.

Revision of Part 347

Effective July 1, 1998, the FDIC revised its Part 347 in order to modernize and clarify various rules for international and foreign banking activities. The new Part 347 reduces filing requirements (now in Part 303 – Subpart J) for most banks wishing to open a foreign branch or make a foreign investment. Well-run, well-capitalized institutions with no enforcement actions pending against them that meet certain other criteria may utilize FDIC's new general consent process when initiating new activities abroad. This means an eligible institution can presume to have the FDIC's approval to engage in certain activities. The institution is required to notify the FDIC after new operations begin. Alternatively, well-run, well-capitalized institutions ineligible to proceed under the

presumption of general consent can now take advantage of expedited processing for their applications. Under expedited processing, applications will be acted upon within 45 days of receipt. However, general consent and expedited processing procedures do not apply if the foreign branch or investment would be located in a foreign country in which applicable law or practice would limit the FDIC's access to information for supervisory purposes. The new rule also:

- Eliminates a general limit on foreign investment of 25 percent of capital. New investment limitations are associated with specific types of activities. The regulation also includes procedures for requesting modifications to the limits.

- Permits a bank's foreign branch to underwrite, distribute and deal, invest in and trade obligations of any foreign government, rather than just the obligations of the country in which it is located. Banks may also invest directly in foreign organizations that are not banks.

- Simplifies accounting for fees on international loans. Instead of requiring specific accounting procedures, the new rule directs banks to follow generally accepted accounting principles (GAAP).

- Requires banks to either establish reserves to account for transfer risk in international assets or use an alternative method consistent with GAAP.

Part 347 was also changed to reflect statutory requirements that a FBO's retail deposit-taking activities in the United States be conducted through an insured bank subsidiary, not an insured branch. This merely implements provisions of the FBSEA, which amended the IBA to require any foreign bank intending to conduct retail deposit activities in the United States to organize an insured bank subsidiary to conduct these deposit activities.

Under the new Part 347, quarterly, not semiannual, calculations and reporting are required for pledged assets that apply to the deposit activities of insured branches. The FDIC requires an insured branch to pledge assets equal to 5 percent of the average of the insured branch's liabilities for the last 30 days of the most recent calendar quarter. Part 347 retains the FDIC's previous requirements regarding the necessity for an insured state branch to apply to the FDIC for approval to conduct or continue an activity which is otherwise not permissible for a federal branch.

H.R. 10

The U.S. Congress has been debating and considering modernization of the U.S. financial system for many years. In the 105th Congress (1997-98), financial modernization legislation made significant progress but was not enacted. On May 13, 1998, the House of Representatives passed H.R. 10, the Financial Services Act of 1998, by a vote of 214-213. On September 18, 1998, the

Senate Committee on Banking, Housing, and Urban Affairs reported H.R. 10 to the full Senate by a vote of 16-2. This legislation was not, however, considered by the Senate before the 105th Congress adjourned. Legislation that is not enacted before a Congress adjourns does not carry over into the next Congress. It is expected that the 106th Congress (1999-2000) will again consider and debate legislation relating to this issue.

H.R. 10, the bill that was under consideration in the 105th Congress, would have repealed provisions in the 1933 Glass-Steagall Act that restrict affiliations and interlocking management and employees between banks and firms engaged in securities underwriting. The bill would have allowed any bank holding company – renamed a financial holding company (FHC) – to control a securities underwriting firm, as well as companies engaged in other types of financial activities, including insurance underwriting, if, among other things, the holding company controlled only well capitalized and well managed banks. Like other bank holding companies, FHCs would have been supervised by the FRB. Securities and insurance affiliates of FHCs would have been functionally regulated under other federal and state securities and insurance laws.

Foreign banks would have been able to be deemed to be FHCs. In determining whether to treat a company as a FHC, the FRB would have been required to establish and apply comparable standards to a foreign bank that operated a branch or agency or owned or controlled a bank or commercial lending company in the United States. In establishing and applying these standards, the FRB would have been required to give due regard to the principle of national treatment and equality of competitive opportunity.

H.R. 10 also would have created a new type of depository institution called a "wholesale financial institution" (WFI). The deposits collected by a WFI would not have been insured by the FDIC and a WFI generally could not have accepted retail deposits of under US$100,000. A foreign bank operating only uninsured branches, agencies, and commercial lending companies in the United States could have requested a determination from the FRB to be treated as a WFI so long as the foreign bank met certain restrictions, including comparable capital requirements and restrictions on affiliate transactions.

Foreign banks that chose to become FHCs or are treated as WFIs under the bill would have lost their grandfather rights to engage in nonbanking activities under the IBA. However, most grandfathered activities and investments would have become generally permissible under H.R. 10 for all FHCs, and H.R. 10 would have permitted other nonconforming investments to be conformed over a certain period, or, in certain cases, held indefinitely. If a foreign bank were engaged in grandfathered activities that became generally permissible for FHCs (e.g., securities underwriting), and the foreign bank did not elect to become an FHC or be treated as a WFI within two years of enactment of the bill, the FRB would have had the authority to impose restrictions on the conduct of the grandfathered activities comparable to those applicable to FHCs.

NATIONAL TREATMENT UNDER U.S. SECURITIES LAWS

The federal securities laws generally provide national treatment to foreign brokers, dealers and investment advisers. In addition, foreign issuers are generally subject to substantially the same registration and reporting requirements as U.S. issuers. In recent years, the Securities and Exchange Commission (SEC) has taken various actions aimed at simplifying access by foreign firms and issuers to the U.S. securities markets without compromising protection of U.S. investors.

Brokers and Dealers

The Securities Exchange Act of 1934 (Exchange Act) gives the SEC broad regulatory authority over the U.S. securities markets and persons in the securities business. Under the Exchange Act, the SEC oversees the activities of broker-dealers, the national securities exchanges, the National Association of Securities Dealers (NASD), clearing organizations, and nonbank transfer agents.

A broker-dealer, other than a U.S. bank, that uses the U.S. mails, or any other means of interstate commerce, to effect transactions in securities generally must register with the SEC. In registering, a broker-dealer is not required to report to the SEC the extent to which it is owned by foreign persons, although it must disclose the identities of certain control persons, whether domestic or foreign.

The SEC's policy with respect to broker-dealers is one of equal market access: the SEC seeks to apply the same requirements to all broker-dealers, whether U.S.- or foreign-owned or U.S.- or foreign-resident. These requirements include filing a registration form with the SEC, satisfying standards of financial responsibility, operational capacity, and integrity, maintaining minimum net capital, and filing reports with the SEC and self-regulatory organizations (SROs). To ensure that it can enforce the securities laws against a nonresident foreign broker-dealer, the SEC requires such a broker-dealer to appoint the SEC as agent for service of process for securities law related to claims arising out of the conduct of its business as a registered broker-dealer in the United States.

Exchange Act Rule 15a-6 exempts from registration foreign broker-dealers that engage in certain activities involving U.S. institutional investors and U.S. securities markets. These activities include "nondirect" contacts by foreign broker-dealers with U.S. investors and markets, through execution of unsolicited securities transactions and provision of research to certain U.S. institutional investors. The exempted activities also include certain "direct" contacts, involving the execution of transactions through a registered broker-dealer intermediary with or for certain U.S. investors, and without such an intermediary with or for registered broker-dealers; banks acting in a broker or dealer capacity; certain international organizations; foreign persons temporarily present in the United States; U.S. citizens resident abroad; and foreign branches and agencies of U.S. persons.

Registered broker-dealers are required to join one or more SROs, such as the national securities exchanges and the NASD. In general, SROs are statutorily authorized and are subject to SEC oversight. An SRO is responsible for compliance by its members with rules of the SRO as well as with the federal securities laws. The Exchange Act specifically limits the ability of the national securities exchanges and the NASD to exclude registered broker-dealers from membership, ensuring that foreign ownership is not a ground for denial of membership. Foreign incorporation, or other organization, of the foreign-owned broker-dealer is not a bar to membership in the NASD and most regional exchanges, but it is a bar to membership in the New York and American Stock Exchanges. These two exchanges permit foreign-owned members, but they require those members to be organized in the United States.

Brokers and dealers whose business is solely in U.S. government securities have been, since 1987, required to register and to meet standards established by the Secretary of the Treasury concerning capital adequacy, protection of customer securities and balances, and record-keeping and reporting. The Government Securities Act of 1986, as amended in 1993, generally does not distinguish between foreign and domestic government securities brokers and dealers. Essentially, government securities brokers and dealers are required to register with the SEC and to become members of an SRO, unless the entity is already registered with the SEC as a broker or dealer or is a financial institution. Government securities brokers or dealers that are already registered with the SEC or that are financial institutions must notify the appropriate regulatory agency of their status as government securities brokers or dealers. The Department of the Treasury has provided an exemption from registration, which parallels SEC Rule 15a-6, for foreign entities that are government securities brokers or dealers.

Investment Advisers

The Investment Advisers Act of 1940 (IAA) establishes a national treatment standard, treating foreign investment advisers substantially the same as domestic advisers that are registered with the SEC. Under the IAA, an investment adviser is defined as a person who, for compensation, "engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or . . . as part of a regular business, issues or promulgates analyses or reports concerning securities. . . ."

As a result of 1996 amendments to the IAA, supervision and regulation of investment advisers is split between the states and the SEC. Certain advisers, such as foreign investment advisers, investment advisers with total assets under management of US$25 million or more, and investment advisers that advise registered investment companies, only register with the SEC. Other investment advisers are now prohibited from registering with the SEC and only register with the states in which they maintain a principal place of business.

Whether domestic or foreign, investment advisers that use the U.S. mails or any means or instrumentality of interstate commerce in connection with their business are required to register with the SEC, unless they are prohibited from registering or an exemption is available. The IAA does not specify particular qualifications for registration. Registered advisers are subject to antifraud provisions (as are unregistered advisers), limitations on advisory compensation, and disclosure and recordkeeping requirements.

The following institutions and professionals are excluded from the definition of investment adviser: U.S., but not foreign, banks and bank holding companies; lawyers, accountants, engineers, or teachers whose investment advice is solely incidental to the practice of their professions. Also excluded are: brokers or dealers whose investment advice is solely incidental to the conduct of their business as brokers or dealers and who receive no special compensation for such advice; publishers of any bona fide newspaper or financial publication of general and regular circulation; and persons giving advice only with respect to U.S. government securities.

In addition, certain types of investment advisers are exempt from the registration requirements of the IAA. These are: any adviser whose clients are all in the state in which the adviser conducts business and who does not advise with respect to securities listed, or with respect to securities having unlisted trading privileges, on a national securities exchange; any adviser whose only clients are insurance companies; and any adviser with fewer than 15 clients who does not hold itself out to the public as an investment adviser and who does not advise registered investment companies. A foreign investment adviser that has its principal place of business outside the United States must only count clients that are U.S. residents for purposes of this exemption.

As noted above, the IAA excludes U.S. banks and bank holding companies from the definition of investment adviser. The SEC also requires an investment adviser, as a prerequisite to registration, to appoint the SEC as agent for service of process for securities law claims arising out of the conduct of its business as a registered investment adviser.

Prior to 1992, the SEC staff generally took the position that once registered, domestic and foreign advisers were subject to all of the substantive provisions of the IAA with respect to both their U.S. clients and non-U.S. clients. Thus, if a foreign adviser registered to advise U.S. clients, the IAA also would apply to its relationship with clients in its own country. The IAA restricts or prohibits some conduct that may be legal in other countries. As a result, some foreign advisers registered in the United States were not able to engage in certain advisory conduct that was legal in their own countries.

Many foreign advisers avoided this result by registering a separate and independent subsidiary to provide advice to their U.S. clients, while the foreign adviser-parent would remain unregistered and would be able to advise non-U.S. clients in its home country without being subject to the IAA. To establish that the foreign parent and the subsidiary were, in fact, separate, and that the parent was

not doing indirectly what it could not do directly, the SEC staff imposed a number of conditions, such as prohibiting the parent and the subsidiary from sharing personnel and investment advice. These conditions made it difficult for the U.S.-registered subsidiaries to advise U.S. clients effectively.

Based on a recommendation in its report, *Protecting Investors: A Half Century of Investment Company Regulation,* May 1992, the SEC staff has determined that the substantive provisions of the IAA generally should not govern a foreign investment adviser's relationships with its non-U.S. clients unless those relationships involve "conduct" or have "effects" in the United States. Foreign advisers must comply with certain recordkeeping requirements with respect to their non-U.S. clients, and also generally must provide the SEC access to their books, records, and personnel.

The SEC staff has issued several no-action letters that apply this approach. These no-action letters also ease the conditions under which a foreign adviser can register a U.S. advisory subsidiary, and thus provide advice to U.S. clients, without requiring the parent itself to register under the IAA. Most importantly, the letters permit the foreign adviser and the U.S. subsidiary to share personnel and investment advice as long as the SEC has access to trading and other records of each affiliate involved in the U.S. advisory activities, and to its personnel, to the extent necessary to monitor and police conduct that may harm U.S. clients or markets. The SEC staff's approach may provide even greater incentives for foreign advisers to register and provide their services to U.S. clients.

Investment Companies

The Investment Company Act of 1940 (ICA) requires registration with the SEC of all nonexempt investment companies. Investment companies required to register under the Act are subject to statutory provisions that regulate, among other things: composition of management and management's accountability to shareholders; approval of investment advisory contracts; changes in fundamental investment policies; transactions between an investment company and affiliated persons; and the capital structure of investment companies.

Under Section 7(d) of the ICA, a foreign investment company (i.e., one not "organized or otherwise created under the laws of the United States or of a State") may not, in connection with a public offering in the United States or to U.S. persons, offer for sale, sell, or deliver its securities through the mails or interstate commerce unless the SEC, by order, finds that it is both legally and practically feasible effectively to enforce the provisions of the ICA against such a company. In effect, the ICA requires the SEC to find that investors in foreign investment companies using U.S. jurisdictional means have the same protections as investors in U.S. investment companies.

Because foreign regulatory schemes differ significantly from the ICA, most foreign funds find it difficult to meet this standard. In 1954, the SEC adopted Rule 7d-1 to set forth minimum conditions and undertakings required for a Canadian company to obtain an order under Section 7(d). All of the

funds that have received exemptive orders under Section 7(d), both Canadian and non-Canadian, have complied with the substantive conditions of Rule 7d-1. Only 19 foreign funds, most from Canada, have ever received Section 7(d) orders, and the SEC last issued an order of this type in 1973.

The SEC is considering proposing a rule to minimize the regulatory burdens that restrict former Canadian residents from effectively managing their assets held in certain Canadian tax-advantaged retirement plans. As part of this rulemaking process, the SEC staff is reviewing recommendations, submitted on behalf of the Investment Funds Institute of Canada, on how the SEC might address this issue by rulemaking.

Because the ICA does not prohibit foreign advisers from organizing funds in the United States, a foreign money manager may organize an investment company in the United States that invests in the same type of securities as a fund it manages in its home country. A number of publicly offered U.S. investment companies invest in foreign securities and many of these funds have advisers or sub-advisers that are located abroad.

Foreign banks (and certain other foreign entities such as foreign insurance companies) may be considered investment companies under the ICA if they are sufficiently involved in holding or trading securities. Section 3(c)(3) of the ICA expressly excepts U.S., but not foreign, banks and insurance companies from the definition of investment company. In October, 1991, however, the SEC adopted Rule 3a-6 under the ICA which excludes foreign banks and insurance companies from the definition of investment company. When the SEC adopted Rule 3a-6, it also rescinded Rule 6c-9, which had conditionally permitted foreign banks and their finance subsidiaries to sell their own debt and non-voting preferred stock in the United States. Finance subsidiaries of foreign banks and insurance companies are now excluded from the ICA under Rule 3a-6.

Issuers

The Securities Act of 1933 (Securities Act) prescribes disclosure and antifraud standards for offerings of securities in the United States, and requires registration of securities with the SEC prior to their offer or sale unless an exemption from registration is available.

Under the Exchange Act, issuers are required to register their securities with the SEC if such securities are to be listed on a national securities exchange, and issuers (other than banks and insurance companies) are required to file reports with the SEC if their securities are to be quoted on the Nasdaq Stock Market. Exchange Act registration is also required if an issuer exceeds certain asset size and shareholder number thresholds. Once its securities are registered under the Exchange Act, an issuer must file annual reports and other periodic reports with the SEC, as well as, in the case of domestic companies, proxy statements. Exchange Act reporting is also required of certain other issuers that have registered securities under the Securities Act.

Foreign Issuers

In principle, public offering and periodic reporting requirements for foreign issuers are the same as those for domestic issuers. Thus, the federal securities laws apply the concept of national treatment to foreign issuers. In practice, the SEC has adjusted its disclosure requirements to accommodate foreign issuers because of differences in legal and accounting practices between countries.

As of June 30, 1998, over 1,100 foreign issuers representing 55 countries were filing Exchange Act reports with the SEC. Over 500 new foreign companies have entered the U.S. markets since January 1994, including companies from Russia, Hungary, and Ghana.

Disclosure. Separate registration and reporting forms have been adopted under the Securities Act and the Exchange Act for use by foreign issuers. Form 20-F, which serves as both a registration statement and an annual report form under the Exchange Act, requires disclosure substantially identical to Form 10-K, the domestic issuer annual report form. As mentioned, certain accommodations have been provided to foreign issuers. These accommodations include limiting management compensation disclosure to disclosure on a group basis (unless the company otherwise discloses individual information pursuant to foreign law or practice) and requiring information on transactions by management only to the extent that such disclosure has been made pursuant to applicable foreign laws. Periodic reports need to be furnished by foreign issuers on Form 6-K only to the extent that the information in such reports is either required to be made public by applicable foreign regulations or required to be distributed to security holders. In addition, the proxy solicitation regulations and regulations pertaining to insider reporting, which are applicable to insiders of domestic issuers, generally do not apply with respect to foreign issuers.

Financial statements for foreign issuers are not required to be prepared in accordance with U.S. generally accepted accounting principles (GAAP), so long as reconciliation of significant variations from those standards is provided.[23] In most U.S. public offerings of securities by foreign issuers, a full reconciliation is required to be presented in accordance with Item 18 of Form 20-F. Item 18 requires the quantification and explanation of material differences in net income and significant balance sheet items and all other disclosures and supplemental data required by U.S. GAAP and Regulation S-X, including data about industry segments, foreign operations, pensions, and leases. In annual reports and for certain U.S. public offerings, stock exchange listings, and quotations on the Nasdaq Stock Market, the issuer need only provide a more limited reconciliation in accordance with Item 17 of Form 20-F. Item 17 requires a quantification of the difference in measurement of net income and significant balance sheet items and an explanation of the nature and financial statement effects of each material difference.

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[23] Regulation S-X contains the SEC's principal accounting requirements, which govern the form and content of financial statements filed under both the Securities Act and the Securities Exchange Act.

The foreign issuer integrated disclosure system allows a foreign issuer to abbreviate the disclosure presented in a prospectus through incorporation by reference of the business, financial and other information presented in Form 20-F. The forms for Securities Act registration by foreign private issuers (Forms F-1, F-2, F-3, and F-4), together with Exchange Act Forms 20-F and 6-K, comprise the integrated disclosure system for foreign issuers. The extent to which an issuer may incorporate information from its Exchange Act reports, rather than physically presenting it in a public offering document, varies depending on the Securities Act form the issuer is eligible to use. The foreign integrated disclosure system is comparable to the domestic integrated disclosure system. The domestic integrated disclosure system is based on Securities Act Forms S-1, S-2, S-3, and S-4, and Exchange Act Form 10-K. Form F-6 is used to register American Depositary Shares (ADSs) represented by American Depositary Receipts (ADRs), which are issued against the deposit of the underlying securities of foreign issuers.

In December 1994, the SEC adopted several amendments to Regulation S-X and Form 20-F designed to further streamline financial information and reconciliation requirements for both foreign and domestic companies.[24] These rules allow foreign issuers more flexibility in their choice of reporting currency, reduce reconciliation requirements for foreign issuers with material operations in a hyperinflationary economy when accounted for in compliance with International Accounting Standard No. 21, and lessen combinations where the method of accounting for the business combination and the amortization period of goodwill and negative goodwill is in compliance with International Accounting Standard No. 22.

In addition, these amendments eliminated the significance threshold based on relative asset size for requiring financial statements of a foreign or domestic equity investee; eliminated six financial schedules for domestic companies which already had been eliminated for foreign issuers; and eliminated two additional financial schedules for both foreign and domestic issuers.

In May 1997, the SEC adopted amendments to expand the availability of the short Forms S-3 and F-3 under the Securities Act.[25] The amendments changed the test for eligibility to include non-voting, as well as voting, common equity in the computation of the required US$75 million aggregate market value of common equity held by non-affiliates of the registrant. The SEC also adopted conforming amendments to other forms and rules.

Exemptions from registration. Exemptions from the registration requirement exist under the Securities Act both for specific types of securities and for specific categories of transactions. For example, Section 3(a)(2) of the Securities Act provides an exemption from registration for securities issued or guaranteed by certain domestic government entities. The exemption does not extend to

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[24]*See* Securities Act Release Nos. 7117, 7118, and 7119 (December 13, 1994).

[25]*See* Securities Act Release No. 7419 (May 8, 1997).

securities issued or guaranteed by a foreign government. Public offerings of such securities are registered under the Securities Act on Schedule B, which provides specialized disclosure requirements for such offerings.

Securities issued or guaranteed by a bank are also not subject to the registration requirements of the Securities Act. This exemption applies only to securities issued or guaranteed by banks, as opposed to bank holding companies or nonbank affiliates of banks. "Bank" is a term defined by the Securities Act to include U.S. banks. The SEC has deemed U.S. branches and agencies of foreign banks to be included in the exemption, provided they are subject to state or federal regulation substantially equivalent to that applicable to U.S. banks doing business in the same jurisdiction.[26]

The SEC also adopted an exemption from registration for ADRs. In July 1997, the SEC adopted the recommendation of the 1996 Task Force on Disclosure Simplification by exempting ADRs from Exchange Act registration when the ADRs are listed on a national securities exchange and registered under the Securities Act.[27] The Exchange Act registration requirements for securities listed on a national securities exchange still apply to the underlying class of securities.

In March 1998, the SEC issued an interpretative release that provides guidance on the application of the registration requirements of the U.S. securities laws to offers of securities made on the Internet by foreign issuers.[28] The release states that, for purposes of the registration requirements only, offshore Internet offers and solicitation activities would not be considered to be made "in the United States" if Internet offerors implement measures that are reasonably designed to ensure that their offshore Internet offers and solicitation activities are not targeted to the United States or to U.S. persons. The determination of whether measures reasonably designed to guard against sales to U.S. persons have been implemented depends on the facts and circumstances, and can be satisfied through different means. The release discusses examples of measures that are adequate to serve this purpose for both U.S. and foreign entities.

State Regulation

In addition to the federal regulatory scheme described above, the 50 states have securities laws, known as "blue sky" laws. Most states require that broker-dealers and non-SEC registered investment advisers active in the state register with the state. The forms used for such registration, however, generally are the same as the forms used for registration under the federal securities laws. As noted above, these forms elicit information about "control persons," and require consents to

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[26] *See* Securities Act Release No. 6661 (September 23, 1986).

[27] *See* Securities Act Release No. 7431 (July 18, 1997).

[28] *See* Securities Act Release No. 7516 (March 23, 1998).

service of process, but do not otherwise distinguish between foreign and domestic firms.

Most states also require that securities offered in the state be registered with the state. Although most states have adopted the Uniform Securities Act of 1956, there are many variations among the states. This means that if an issuer makes a public offering in the United States, it must register, or find an exemption from registration, in each state where the offering will be made. This "blue sky" process does not differ substantially, however, for domestic and foreign issuers.

The National Securities Markets Improvement Act of 1996 revised Section 18 of the Securities Act to reallocate regulatory responsibility relating to securities offerings between the federal and state governments based on the nature of the security offering. Among other things, the revised statute prevents states from directly or indirectly prohibiting, limiting, or imposing any conditions on the use of any offering document for a covered security if the offering document is prepared by or on behalf of the issuer. Section 18 defines the term "covered security," which includes securities listed on the New York Stock Exchange, the American Stock Exchange, the National Market System of the Nasdaq Stock Market, and securities issued in certain exempt offerings. The SEC adopted new rule 146 to provide a definition of the term "prepared by or on behalf of the issuer."[29] It provides that if an issuer or agent or representative authorizes an offering document's production and approves the document before its use, it is deemed prepared by or on behalf of the issuer. Revised Section 18 and new Rule 146 apply to both domestic and foreign issuers.

Summary

In the securities sector, regulators have taken a number of steps to simplify access by foreign firms and issuers to U.S. securities markets without compromising investor protection. The SEC's policy with respect to broker-dealers is one of equal market access: the SEC seeks to apply the same requirement to all broker-dealers, whether U.S.- or foreign-owned, or U.S. or foreign resident. The Investment Advisers Act of 1940 establishes a national treatment standard, treating foreign investment advisers substantially the same as domestic advisers that are registered with the SEC. The SEC has modified and simplified certain disclosure requirements that facilitate access to U.S. capital markets for foreign issuers, including accepting accounting methods relating to hyperinflationary economies and business combinations that comply with international accounting standards. Over 500 new foreign companies have entered the U.S. markets since January 1994.

[29] *See* Securities Act Release No. 33-7418 (April 30, 1997).

NATIONAL TREATMENT UNDER U.S. COMMODITIES LAWS

The CEA and implementing rules govern transactions involving futures and commodity options both on exchange and over the counter.[30] Under the CEA, the CFTC regulates transactions conducted on the 12 domestic U.S. futures exchanges (contract markets in futures and options). It also regulates futures and option transactions conducted for or on behalf of U.S. customers on both domestic and foreign markets.

Banks are major participants – both as end-users and as financial intermediaries – in the large and developing swap transactions market. The CFTC has rules (Part 35) that exempt swap agreements meeting specified criteria from the provisions of the CEA and the CFTC's rules, although they are subject to the antifraud and antimanipulation provisions of the CEA as well as Section 2(a)(1)(B) of the CEA, which delineates CFTC and SEC jurisdiction. Banks are the first listed category of eligible swap participants under Part 35 of the CFTC's rules, and domestic and foreign banks are treated equally in this context.

The marketing of "hybrid" instruments that couple elements of futures contracts with certain banking instruments such as depository obligations has raised issues concerning the treatment of such instruments by the CFTC under the CEA and CFTC rules. The CFTC has rules (Part 34) that exempt certain hybrid instruments and those transacting in and/or providing advice or other services with respect to such hybrids from all provisions of the CEA except Section 2(a)(1)(B), provided that a number of conditions are met. A hybrid instrument can be an equity or debt security, or a demand deposit, time deposit or transaction account, provided certain other criteria are met. The demand deposit, time deposit or transaction account can be offered by a domestic bank or insured credit union, as well as a branch or agency of a foreign bank.

In general, a financial intermediary engaged in transactions involving futures and option contracts regulated by the CFTC will be deemed to be subject to CFTC jurisdiction if it meets one of the following four criteria: (1) it is legally domiciled in the United States; (2) it is physically present in the United States; (3) it has consented to jurisdiction; or (4) it is conducting business in the United States by dealing with persons located in the United States. A financial intermediary conducting business in the United States need not be physically present in the United States. No distinction is made in the CEA and rules thereunder between solicited and unsolicited business.

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[30] Excluded are foreign currency options traded on a national securities exchange and options on securities and on securities indexes, which are regulated by the SEC. *See* Sections 2(a)(1)(B) and 4c of the CEA. In addition, the Treasury Amendment of the CEA states: "Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade." Section 2(a)(1)(A)(ii) of the CEA. In addition to statutory exclusions, the CFTC has the authority to grant specific exemptions under Section 4(c) of the CEA.

Under the CEA, a foreign firm doing business in the United States is accorded national treatment, including equality of competitive opportunity, and is treated no less advantageously than a domestic firm.

Transactions on U.S. Markets

The CEA generally requires that trading of commodity futures and option contracts in the United States must be conducted on or subject to the rules of a board of trade that has been designated by the CFTC as a contract market unless the transactions are otherwise exempt. In 1997, the CFTC implemented new "fast-track" procedures for processing contract market designation applications and exchange rule changes to streamline further the CFTC's review procedures. Under these procedures, many applications for designation of cash-settled and nonagricultural futures and options contracts (other than stock index futures or options thereon) may be deemed to be approved 10 days – and many other applications, 45 days – after receipt unless the exchange is notified otherwise.

The CFTC, as part of its efforts to modernize and to streamline its rules, has undertaken, in addition to the "fast-track" review procedures, the following regulatory reform initiatives over the last four years:

- Adoption of risk assessment rules for holding company systems, which require FCMs to maintain records and file reports about affiliates whose activities are likely to affect materially the FCM's operations or financial condition; these rules also require FCMs to file a statement concerning their internal control policies for handling risk originating from material affiliates.[31]

- Adoption of substantial revisions to the disclosure framework applicable to CPOs and CTAs.[32]

- Adoption of rule amendments to harmonize further financial reporting requirements of the CFTC with those of the SEC for FCMs and IBs that are also registered with the SEC.[33]

- Adoption of an amendment to the large trader reporting rules to require a large trader to file

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[31] 59 Fed. Reg. 66674 (Dec. 28, 1994).

[32] 60 Fed. Reg. 38146 (July 25, 1995).

[33] 62 Fed. Reg. 4633 (Jan. 31, 1997).

the Statement on Form 40 only when requested to do so by the CFTC, rather than annually.[34]

- Numerous initiatives designed to enable market participants to reduce costs and increase efficiency through the use of electronic media, including: (1) permitting FCMs to file required financial reports with the CFTC electronically;[35] (2) allowing CPOs and CTAs to file their required Disclosure Documents electronically;[36] (3) permitting FCMs to deliver monthly statements, trade confirmation and purchase-and-sale statements solely by electronic transmission in lieu of hard-copy delivery;[37] (4) issuing an Interpretation regarding the use of electronic media by CPOs and CTAs for delivery of Disclosure Documents and other materials;[38] and (5) proposing amendments to the recordkeeping requirements that would expand the opportunities for use of micrographic and electronic storage media for recordkeeping and eliminate the current requirement that paper records eligible for transfer to micrographic storage media be maintained in hard copy for two years.[39]

- Delegation of functions to the National Futures Association (NFA), the industry-wide SRO, including: (1) decisions relating to the registration of floor brokers (FBs)[40] and floor traders (FTs)[41] with prior disciplinary histories;[42] (2) conduct of various registration and processing functions relating to non-U.S. firms;[43] and (3) review of the Disclosure Documents that CPOs and CTAs are required to file.[44]

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[34] 62 Fed. Reg. 6112 (Feb. 11, 1997).

[35] 62 Fed. Reg. 10441 (March 7, 1997).

[36] 62 Fed. Reg. 18265 (Apr. 15, 1997).

[37] 62 Fed. Reg. 31507 (June 10, 1997).

[38] 62 Fed. Reg. 39104 (July 22, 1997).

[39] 63 Fed. Reg. 30668 (June 5, 1998).

[40] An FB is an individual who executes orders for another person for the purchase or sale of futures and commodity option contracts on the floor of a contract market. An FB can also trade for his or her own account.

[41] An FT is an individual who executes futures or commodity option orders solely for his or her own account on the floor of a contract market.

[42] 62 Fed. Reg. 36050 (July 3, 1997).

[43] 62 Fed. Reg. 47792 (Sept. 11, 1997).

[44] 62 Fed. Reg. 52088 (Oct. 6, 1997).

- Proposal of rules to establish specific procedures for filing requests for no-action, exemptive and interpretative letters.[45]

- Adoption of rule amendments whereby FCMs and IBs are no longer required to provide mandatory risk disclosure materials to certain defined categories of financially sophisticated customers.[46]

- Proposal of rules to require CPOs of public pools to issue a two-part Disclosure Document, the first part of which is limited to specific information using "plain English" principles.[47]

- Adoption of interim final rules for a three-year pilot program for trade options on enumerated agricultural commodities, which includes a delegation to NFA concerning registration functions.[48]

- Issuance of an Advisory to emphasize the importance for all CFTC registrants to take immediate action to avoid the serious disruptions that could be caused by the use of computer technology that is not year 2000 compliant.[49]

- Elimination of the capital charge for FCMs carrying short option positions for customers.[50]

- Adoption of rules that would allow exchanges to permit futures-style margining of options contracts.[51]

- Adoption of a rule to permit post-execution allocation of bunched orders of sophisticated customers where the FCM has obtained the customer's consent.[52]

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[45] 63 Fed. Reg. 3285 (Jan. 22, 1998).

[46] 63 Fed. Reg. 8566 (Feb. 20, 1998).

[47] 63 Fed. Reg. 15112 (March 30, 1998).

[48] 63 Fed. Reg. 18821 (Apr. 16, 1998).

[49] CFTC News Release No. 4140-98 (Apr. 29, 1998).

[50] 63 Fed. Reg. 32725 (June 16, 1998).

[51] 63 Fed. Reg. 32726 (June 16, 1998).

[52] 63 Fed. Reg. 45699 (Aug. 27, 1998).

- Adoption of a rule to require an FCM to notify the CFTC and the firm's designated SRO immediately whenever the firm knows or should know that it has insufficient funds in segregated accounts to meet its obligations to its customers, issued in response to the market events of October 1997.[53]

Customer and market protection. The domestic regulatory program contemplated by the CEA focuses on both market and customer protection. The CEA and rules adopted thereunder establish a comprehensive regulatory structure that is intended to prevent fraud and other wrongful conduct involving futures contracts and commodity options. The rules applicable to market protection generally address prevention of market manipulations and other price distortions in the cash and futures markets. The customer protection aspect of the regulatory regime includes:

1. *Registration requirements intended to ensure the "fitness" of all persons who deal with customers or customer funds.* The CEA and rules adopted thereunder govern registration requirements for FCMs, IBs, CPOs, CTAs, associated persons (APs) of any of the foregoing categories of firms,[54] FBs, FTs and broker associations.[55]

2. *Minimum financial requirements for FCMs and IBs.* These requirements address the financial integrity of the markets and persons transacting business on such markets. They ensure that firms have sufficient funds to operate the business and have some financial stake in their business and that, in the event of customer default on a margin obligation to an FCM, there will exist a cushion so that other customer funds will not be adversely affected.

3. *Segregation of customer funds from an FCM's proprietary funds.* A primary purpose of this requirement is to prevent the use of customer funds for purposes other than those specified by the customer and to provide protections to such funds from creditors of the carrying firm in the event of its financial failure.

4. *A comprehensive sales practice program* to prevent fraudulent and misleading sales practices in the marketing and handling of customer accounts. In addition to antifraud provisions, the CEA and rules thereunder require: (a) disclosure of material information; (b) specific customer authorization for each trade or a written authorization by the customer allowing trading without specific authorization of each trade; (c) issuance to customers of daily

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[53] 63 Fed. Reg. 45711 (Aug. 27, 1998).

[54] An AP is an individual who is associated with an FCM, IB, CPO or CTA, who solicits or accepts customer orders, pool participation interests or discretionary accounts, or who supervises any person engaged in such activities.

[55] A broker association is composed of two or more exchange members who: (1) share responsibility for executing customer orders; (2) have access to each other's unfilled customer orders as a result of common employment or other types of relationships; or (3) share profits or losses associated with their brokerage or trading activity.

confirmations of transactions as well as a monthly account statement; (d) supervision of customer accounts by registrants; and (e) vicarious liability for acts and omissions of employees and agents, as well as aiding and abetting and controlling person liability.

5. *Compliance activities* undertaken by the CFTC and the futures industry SROs. The CEA and rules thereunder impose specific regulatory responsibilities on the exchanges and NFA to maintain extensive programs to assure the integrity of the markets and the participants they supervise. The CFTC oversees the operations of these SROs, which are subject to CFTC enforcement action for failure to comply with the CEA and rules thereunder.

6. *Recordkeeping and reporting requirements*. These are intended to assist in determining whether a registrant is acting in accordance with the provisions of the CEA and the rules, regulations and orders thereunder.

7. *Ethics training*. These requirements are designed to insure that registrants understand their responsibilities to observe just and equitable principles of trade, any rule or regulation of the CFTC, applicable exchanges, registered futures association (i.e., NFA) or other self-regulatory organization, or any other applicable federal or state law, rule or regulation. New registrants must attend four hours of training within six months of becoming registered, and one hour every three years thereafter.

Any person, whether domestic or foreign, who conducts business on a domestic contract market for a U.S. customer is subject to compliance with the full panoply of customer protections described above.

When a person conducts business on a domestic market for a foreign customer, however, the determination as to whether that person is subject to CFTC regulation generally is a function of where that person is deemed to be located. For example, if the person conducting business is deemed to be located within the United States, that person will be required to register and otherwise to comply with all of the CFTC's regulatory requirements applicable to registrants. If the person is located outside of the United States and is acting on U.S. markets in the capacity of, for example, a broker with respect to foreign customers, that person may be subject to reporting requirements as a "foreign broker."

"Foreign brokers" generally are defined as persons located outside of the United States that carry accounts in futures or options solely for or on behalf of non-U.S. persons on U.S. markets through a registered FCM. Foreign brokers are not required to register with the CFTC as FCMs; however, they remain subject to, among other things, large trader reporting requirements. The CFTC has also stated that a foreign broker acting in the capacity of an IB would generally not need to register as an IB. Similarly, persons located outside the United States who act in the capacity of a CPO or CTA with respect to non-U.S. persons, even if the transactions are conducted on or subject to the rules of

a U.S. contract market, need not register as CPOs or CTAs.

With respect to FCMs and IBs, most foreign firms that desire to engage in such activities choose to do so by means of a U.S.-based subsidiary or affiliate which, among other things, facilitates U.S. client contact. In addition, an offshore applicant's failure either to maintain an office in the United States or to demonstrate that it has procedures to ensure CFTC and NFA access to its books and records may constitute grounds upon which registration may be denied.

Transactions on Non-U.S. Markets

Prior to 1987, the sale of most foreign futures to U.S. customers was essentially unregulated.[56] Thus, firms in the United States and overseas could offer and sell these products to U.S. customers subject only to a general antifraud provision. The offer or sale of foreign options, with minor exceptions, had been banned since 1978. In 1987, CFTC adopted comprehensive rules, which are contained in Part 30 of the CFTC's rules, to govern the offer or sale of any foreign futures or options contract to a person resident in the United States

Any person, whether located in the United States or outside of the United States, who transacts business for U.S. customers on foreign markets must register in the appropriate capacity. The Part 30 rules generally parallel the requirements applicable to persons who act in the capacity of an FCM, IB, CPO, CTA or AP in domestic markets. In general, the Part 30 rules extend existing regulatory requirements relating to intermediaries of domestic products offered in the United States to intermediaries of foreign futures and option products with respect to registration, sales practices (including disclosure), capital adequacy, protection of customer funds, compliance, recordkeeping and reporting requirements. However, there are two areas in which the Part 30 rules depart from the regulatory regime applicable to intermediaries in domestic transactions. First, under Rule 30.5, persons who act in the capacity of an IB, CPO or CTA from a location outside the United States may be exempt from the CFTC's registration requirements, provided that all of their U.S. customer accounts are carried by or through a U.S. FCM or a firm with a Rule 30.10 exemption and the customers are sophisticated. Such persons must otherwise comply with certain other requirements of the CFTC's rules (e.g., the risk disclosure requirements of CFTC Rule 30.6). Such persons also must enter into an agreement, filed with NFA, with an appropriate agent (either the FCM or Rule 30.10 firm carrying the customer accounts or NFA) for the purpose of receiving communications from the CFTC, the Department of Justice, relevant SROs and customers who do business with such persons and must provide to the CFTC and the Department of Justice access to their books and

[56] However, a foreign exchange-traded futures contract based on a stock index could not be offered or sold to U.S. customers unless the CFTC's Office of the General Counsel issued a no-action letter with respect thereto. Similarly, before a futures contract or an option thereon involving a foreign sovereign debt obligation could be offered or sold in the United States, the SEC had to designate the obligation as an "exempted security" under § 240.3a12-8 of the SEC's rules.

records within 72 hours of the request. As of May 1998, 18 firms operated under this exemption. The other area in which the CFTC's regulatory regime for intermediaries of foreign transactions differs from that applicable to intermediaries of domestic transactions relates to persons acting in the capacity of an FCM. Specifically, under Rule 30.10, such persons may apply for an exemption from the FCM registration requirement by virtue of the "comparability" of the rules in effect in the person's home country jurisdiction.

Comparability

Under CFTC Rule 30.10, persons located outside the United States, who solicit or accept orders and related funds from U.S. customers for foreign futures or options transactions and who are subject to a *comparable regulatory scheme* in their home country jurisdiction, may apply for an exemption from the application of certain of the Part 30 rules. To accommodate the increasing internationalization of futures markets and the CFTC's desire to facilitate cross-border transactions, the comparability approach permits substituted compliance with the regulatory system of another jurisdiction in lieu of compliance with the Part 30 rules. It is an effort both to avoid duplicative regulation of a foreign person and to avoid regulatory gaps.

The CFTC's comparability program consists of a two-tiered analysis. First, the CFTC reviews the rules of the applicable foreign regulator or SRO and will grant exemptive relief based upon an assessment that the rules serve as an adequate substitute for compliance with the Part 30 rules.[57] The CFTC has broad discretion to determine that the purposes of any program element generally are met, notwithstanding the fact that the offshore program does not contain an element identical to that of the CFTC's regulatory program. The CFTC also may determine to provide an exemption for certain portions of another jurisdiction's regulatory program but not for other portions. In considering each petition, the CFTC has consulted extensively with foreign regulators and SROs in assessing the comparability of the foreign regulatory regime.

Second, as a condition of granting comparability relief to a specific firm, the CFTC requires that each firm requesting exemptive relief must be sponsored by its regulator or SRO and must provide certain consents and representations.[58] The firm must be regulated fully by the country whose

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[57] The minimum elements of a comparable regulatory program include: (a) registration, authorization or other form of licensing, fitness review or qualification of persons through whom customer orders are solicited and accepted; (b) minimum financial requirements for those persons who accept customer funds; (c) protection of customer funds from misapplication; (d) recordkeeping and reporting requirements; (e) minimum sales practice standards, including disclosure of the risks of futures and option transactions, in particular the risk of transactions undertaken outside the jurisdiction of domestic law; and (f) compliance mechanisms.

[58] These consents and representations include, among other things: (a) consent to jurisdiction in the United States by filing an appointment of an agent for service of process; (b) consent to provide immediate access to its books and records (which may be effected through a foreign regulator); (c) consent to participate in an arbitration program

regulatory scheme was reviewed for comparability with that of the United States prior to granting the orders.[59]

To date, the CFTC has approved the petitions submitted by exchanges, SROs, and governmental entities in eight jurisdictions: Australia – Sydney Futures Exchange (SFE); Canada – the Montreal Exchange and the Toronto Futures Exchange; France – the Commission des Opérations de Bourse on behalf of the Marché à Terme International de France (MATIF); Japan – the Tokyo Grain Exchange; New Zealand – New Zealand Futures and Options Exchange, Ltd. (NZFOE); Singapore – the Singapore International Monetary Exchange (SIMEX); Spain – MEFF RENTA FIJA (MEFF Sociedad Rectora de Productos Financieros Derivados de Renta Fija, S.A.) and MEFF RENTA VARIABLE (MEFF Sociedad Rectora de Productos Financieros Derivados de Renta Variable, S.A); and the United Kingdom – the Securities and Investment Board (SIB), the Securities and Futures Authority (SFA), and the Investment Management Regulatory Organisation (IMRO). As of May 1998, as detailed below, CFTC and NFA had confirmed comparability relief for 179 firms under these orders.

CFTC staff is currently reviewing petitions for relief under Rule 30.10 submitted by Canada's Winnipeg Commodity Exchange and Malaysia's Kuala Lumpur Commodity Exchange.

The CFTC has issued orders permitting foreign firms that have comparability relief under Rule 30.10 to engage in limited marketing activities of foreign futures and options products from locations within the United States. Prior to issuance of these orders in 1992 and 1994, Rule 30.10 relief was available only to qualified firms that solicited customers from a foreign location. The CFTC orders permit Rule 30.10 firms and their employees or other representatives to market foreign futures and option products to qualified customers from a U.S. location, under certain circumstances.

Relief under these orders is limited to firms with Rule 30.10 relief whose:

- regulator or SRO agrees to supervise such firms' conduct in the United States;

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implemented by NFA for nonmember firms in connection with customer disputes involving foreign futures and options; (d) consent that all futures or options transactions will be made on or subject to the rules of an exchange located outside the United States; (e) representation that no principal of the firm would be disqualified from doing business under the CEA; and (f) disclosure of the identity of any U.S. affiliate or subsidiary that is engaged in a related business.

[59] *See*, e.g., CFTC Interpretative Letter No. 98-12 [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,263 (Dec. 30, 1997) (foreign firm not granted Rule 30.10 relief where, among other things, the firm was doing business in, but was not domiciled in, the country whose regulatory framework was reviewed for comparability ("host" country) and the firm would be regulated in part by its "home" country rather than solely by the host country as contemplated under the CFTC's orders).

- marketing activities in the United States do not in the aggregate exceed 30 business days in any calendar year; and

- U.S. customers are persons who have a high degree of sophistication and/or substantial financial resources as specifically provided in the orders.

The CFTC has determined that this further relief is applicable to members of the Montreal Exchange, France's MATIF, the United Kingdom's SIB, SFA, and IMRO, and Australia's SFE.

In 1996 and 1997, the CFTC issued orders under Part 30 to clarify that Rule 30.10 firms in certain countries are permitted to trade for U.S. customers on all non-U.S. exchanges where such firms are permitted under the laws of their home country to engage in such futures and options transactions. In particular, these orders clarify that funds provided by U.S. customers will receive equivalent protection at all intermediaries, exchanges and clearing organizations.[60]

Other International Activities

On March 12, 1996, the CFTC amended Rule 30.3(a) to eliminate the requirement that the CFTC issue an order authorizing the offer or sale of a particular foreign exchange-traded commodity option before it can be offered or sold in the United States However, this rule change did not affect existing CEA product restrictions related to stock indexes and foreign government debt. Therefore, the rule amendment provides that if the underlying foreign exchange-traded futures product (including futures on stock indexes and on foreign government debt) may be offered or sold in the United States, the foreign option based on that futures contract may be offered or sold in the United States as well as without further action.[61]

The CFTC has worked with regulators in other countries to establish international principles of regulation and information sharing. At the CFTC's prompting, international regulators of commodity markets recently adopted best practices standards for market surveillance of commodity futures markets, for information sharing relating to the regulation of such markets, and for contract design and approval.[62] These are the first internationally agreed standards of regulation for these markets, and their adoption is a significant step towards harmonizing international regulation. The

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[60] *See* CFTC Orders for firms designated by the: (1) NZFOE, 61 Fed. Reg. 64985 (Dec. 10, 1996); (2) the Montreal Exchange, 62 Fed. Reg. 8875 (Feb. 27, 1997); (3) SFE, 62 Fed. Reg. 10445 (March 7, 1997); (4) SFA, 62 Fed. Reg. 10447 (March 7, 1997); and (5) IMRO, 62 Fed. Reg. 10449 (March 7, 1997).

[61] 61 Fed. Reg. 10891 (March 18, 1996).

[62] Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts and Guidance on Components of Market Surveillance and Information Sharing, Endorsed by 16 Regulatory Authorities on October 31, 1997, adopted in the Tokyo Communiqué on Supervision of Commodity Futures Markets, October 31, 1997.

CFTC is working through IOSCO to extend these standards to financial derivatives generally and to clarify that the guidance in the Tokyo Communiqué should apply to products other than futures contracts settled by physical delivery for which the underlying commodity is of finite supply. The CFTC has also participated in IOSCO's project on Core Principles of Securities Regulation, which resulted in production of a consultative document in May 1998. The CFTC also helped to organize the Windsor Meeting in London in 1995, which resulted in an agreed action plan by 16 futures market regulators from around the world concerning protection of customer funds, default procedures, surveillance of large exposures, cooperation during market emergencies, and contingency planning.

Electronic Trading Systems

Currently, four electronic trading systems are in operation at U.S. futures exchanges: the Chicago Board of Trade's (CBT) Project A; the Chicago Mercantile Exchange's (CME) Globex; the New York Mercantile Exchange's ACCESS; and the Cantor Financial Futures Exchange (CFFE), which was established pursuant to an agreement between the New York Cotton Exchange, a wholly-owned subsidiary of the New York Board of Trade, and CFFE, LLC, a subsidiary of Cantor Fitzgerald, LP. Since the inception of Globex and Project A trading in 1992 and ACCESS trading in 1993, the volume of trading on these systems has continued to grow. However, because these systems operate almost exclusively after the close of regular floor trading hours, and thus complement rather than compete with traditional open outcry pit trading, electronically traded volume remains a small percentage of overall futures trading. For example, during 1997 approximately 243 million contracts were executed on the CBT floor, and approximately six million contracts were executed using Project A. Although Globex originally was intended as an after-hours system for trading products otherwise traded on the floor of the CME, the CME now trades E-mini Standard and Poor's 500 contracts both on Globex and on the floor of the CME, depending upon the size of the order, during regular trading hours. The CME launched a new electronic system, "GLOBEX2," in September 1998 in a joint venture with MATIF. GLOBEX2 uses a new system architecture that replaces that previously used by the Globex system and rules related to the new system are subject to CFTC approval. CFFE is a computer-based trading system for futures on U.S. government securities, whereby exchange members transmit orders by telephone to terminal operators acting as agents for CFFE, who enter orders into the system for execution. The CFTC designated CFFE as a contract market on September 4, 1998, and trading began on September 8, 1998.

Memoranda of Understanding

The CFTC has cooperated with many foreign regulatory authorities through formal and informal arrangements to combat fraudulent and other prohibited practices that could harm customers or threaten market integrity. As of March 1998, the CFTC had entered into 44 such bilateral arrangements, consisting of regulatory and enforcement MOUs, cooperative arrangements and financial information-sharing agreements (FISMOUs) with regulators in 21 jurisdictions, including

Canada, the United Kingdom, France, the Netherlands, New Zealand, Switzerland, Spain, Brazil, Australia, Singapore, Taiwan, Japan, Italy, Argentina and Mexico. In 1997, arrangements for cooperative enforcement were concluded with South African and German authorities. The CFTC also exchanges information and cooperates in enforcement and regulatory matters on a case-by-case basis with foreign regulatory, law enforcement, and self-regulatory authorities in many countries. The CFTC also participates in a multilateral arrangement including 25 jurisdictions related to sharing information on large exposures and information necessary to deter and to detect manipulative and other abusive practices.

The CFTC views information sharing and other cooperative arrangements as vehicles to permit the CFTC better to protect the integrity of the markets and their participants by addressing cross-border fraud and manipulation and assessing more accurately the financial risks of market participants, including the potential cross-border effect of within-border financial problems. For example, the CFTC's MOUs typically provide for access to official documents and information already in the possession of the authorities. Enforcement arrangements also provide the ability to obtain documents and to take testimony of, or statements from, witnesses.

Summary

As noted above, the CFTC has undertaken a wide-ranging regulatory reform agenda in recent years so that U.S. markets continue to remain competitive in the world while maintaining essential customer and market protections. The CFTC has also been a leader in international forums such as IOSCO in the pursuit of harmonized regulatory standards on a global basis, while at the same time pursuing multilateral and bilateral MOUs. The CFTC continues to permit U.S. customers to participate in global markets through innovative programs such as comparability relief, which also permits non-U.S. firms access to U.S. customers.

CONCLUSION

This chapter has examined key developments in the treatment accorded to foreign financial institutions and products in the U.S. market since the 1994 report was published. In banking, the supervision of the operations of foreign banks in the United States has been improved and streamlined, most individual states have enacted legislation that enhances the ability of both domestic and foreign banking organizations to expand geographically in the United States, the ability of banking organizations to engage in securities activities has been expanded, and several regulatory initiatives have been introduced to reduce regulatory burden on banking organizations, both domestic and foreign, in the United States.

In the securities sector, regulators have taken a number of steps to simplify access by foreign firms and issuers to the U.S. securities markets without compromising protection of U.S. investors.

Disclosure requirements have been modified to facilitate access to U. S. capital markets, resales of certain restricted securities have been exempted from SEC registration requirements, and the SEC has issued no-action letters which ease the conditions under which investment advisers can register in the United States and provide advice to U.S. clients, thus providing further incentives for foreign advisers to provide services to U.S. clients.

The CFTC continued to facilitate access by U.S. customers to foreign risk management instruments, enhanced the legal certainty of certain novel derivatives instruments, and implemented measures to facilitate 24-hour trading of U.S. and foreign exchange-traded products on approved electronic trade execution systems.

Developments in U.S. law and regulation generally have been consistent with the principle of according national treatment to foreign financial institutions and have improved the access of foreign financial services providers to U.S. financial markets.