CTQ-2014-00001

# Court of Appeals

*of the*

# State of New York

MOTOROLA CREDIT CORPORATION,

*Appellant-Respondent,*

– against –

STANDARD CHARTERED BANK,

*Respondent-Appellant.*

*On Question Certified by the United States Court of Appeals for the Second Circuit (USCOA Docket Nos. 13-2535-cv(L) and 13-2639-cv(con))*

## BRIEF OF INSTITUTE OF INTERNATIONAL BANKERS, THE CLEARING HOUSE ASSOCIATION L.L.C., EUROPEAN BANKING FEDERATION AND NEW YORK BANKERS ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT-APPELLANT

DWIGHT A. HEALY
ERNEST T. PATRIKIS
OWEN C. PELL
MARIKA M. LYONS
WHITE & CASE LLP
1155 Avenue of the Americas
New York, New York 10036
Tel.: (212) 819-8200
Fax: (212) 354-8113

*Attorneys for Amici Curiae*

Date Completed: July 21, 2014

## CORPORATE DISCLOSURE STATEMENT

Pursuant to New York Court of Appeals Rule of Practice 500.1(f), the Institute of International Bankers states that it is a not-for-profit corporation and that it has no parent, subsidiary or affiliate.

The Clearing House Association L.L.C. ("The Clearing House") states that it has no parent or subsidiary corporations. The Clearing House is affiliated with The Clearing House Payments Company L.L.C. and New York Clearing House Building Company.

The New York Bankers Association ("NYBA") states that it has no parent, that it has two subsidiaries, New York Bankers Service Corporation and the Circuit Agency, Inc., and that it is affiliated with the New York State Bankers Group Creditors Trust (the "Group Creditors Trust") and the New York State Bankers Group Employee Insurance Trust. NYBA further states that its affiliate the Group Creditors Trust owns the Trustees Life Insurance Company.

The European Banking Federation states that it is incorporated in Belgium as an international non-profit association and that it has no parent, subsidiary, or affiliate.

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## STATEMENT OF INTEREST OF AMICI CURIAE

The Institute of International Bankers ("IIB") is the only national association devoted exclusively to representing, advancing and protecting the interests of the international banking community in the United States, with a membership comprised of internationally headquartered banks and financial institutions from over thirty-five countries that have operations throughout the U.S., particularly in New York. U.S. operations of IIB members have assets of approximately $5 trillion, are an important source of credit for U.S. borrowers, enhance the depth and liquidity of U.S. financial markets, and contribute more than $50 billion each year to the economies of major cities across the country.

Established in 1853, The Clearing House Association L.L.C. ("The Clearing House") is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the U.S. and hold more than half of all U.S. deposits. The Association is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs, and white papers – the interests of its member banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-

house, funds-transfer, and check-image payments made in the United States.

The New York Bankers Association ("NYBA") is an association comprised of approximately 150 community, regional and money center commercial banks in New York with over 200,000 employees in the State. A number of NYBA's member banks are internationally headquartered and many conduct business internationally as well as in New York.

The European Banking Federation ("EBF") is the leading professional organization of European banks. It provides a forum for European banks to discuss best practices and legislative proposals and to adopt common positions on matters affecting the European banking industry. EBF also actively promotes the positions of the European financial services industry, and the banking industry in particular, in international fora.

The IIB, The Clearing House, NYBA, and EBF (the "*amici*") appear as *amici curiae* regularly on matters that raise legal issues of significance for their member banks and in particular have supported the role of the United States in general and New York in particular as an international financial center. The *amici* have a substantial interest in this action because of the adverse precedent it could set for their member banks, and for all international banks with branches or offices in New York. As set forth in more detail below, a rule that authorizes post-judgment, global restraint (or turnover) of accounts maintained or assets held at

non-U.S. branches or offices of international banks with New York branches or offices would create serious problems for international banks doing business in New York, and would adversely affect New York's position as a pre-eminent financial center.

## PRELIMINARY STATEMENT[1]

This Court has been asked to determine whether the separate entity rule remains viable in the context of an extraterritorial post-judgment restraining order and thus "precludes a judgment creditor from ordering a garnishee bank operating branches in New York to restrain a debtor's assets held in foreign branches of the bank." Tire Eng'g and Distrib. L.L.C. v. Bank of China Ltd., 740 F.3d 108, 110 (2d Cir. 2014). The separate entity rule provides that, even if a bank is subject to personal jurisdiction in New York, the branches and offices of the bank outside of New York will be treated as separate and juridically distinct entities for purposes of pre-judgment attachment and judgment enforcement. The rule recognizes the unique role and importance that international banking serves in New York and the

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[1] The following definitions are used herein: appellant-respondent Motorola Solutions Credit Company, LLC ("Motorola"); respondent-appellant Standard Chartered Bank ("SCB"); Brief of Appellant-Respondent Motorola Solutions Credit Company, LLC, dated April 21, 2014 ("Motorola Br."); Brief for Respondent-Appellant Standard Chartered Bank, dated June 5, 2014 ("SCB Br."); Reply Brief of Appellant-Respondent Motorola Solutions Credit Company, LLC, dated June 16, 2014 ("Motorola Reply"); Federal Reserve Bank of New York ("FRBNY"); FRBNY amicus brief filed in Samsun Logix Corp. v. Bank of China, et al., Index No. 105262/2010 (N.Y. Sup. Ct. 2010), Mot. No. 004 ("FRBNY Samsun Amicus"); FRBNY amicus brief filed in Amaprop Ltd. v. Indiabulls Fin. Servs. Ltd., 12-788-cv(L) (2d Cir. June 4, 2013) ("FRBNY Amaprop Amicus"). The *amici* have included with this brief an Addendum ("AMI-ADD") that includes copies of sources cited by the *amici* that may be difficult to locate.

severe practical and legal problems posed for international banks if pre-judgment attachments, restraints, and other enforcement devices issued in New York judgment enforcement actions are found to extend to non-U.S. assets or accounts located abroad.

In its briefs in this case, Motorola argues that any purpose served by the separate entity rule has long since ceased to exist; that the rule is a legal fiction created by a few lower courts that, if it exists at all, applies only in the pre-judgment attachment context; and that the rule was sub silentio overruled in the post-judgment context by the New York Legislature with the adoption of the C.P.L.R. in 1962 and subsequently impliedly repudiated by this Court's decisions in Koehler v. Bank of Bermuda, 12 N.Y.3d 533 (2009), and Commonwealth of the N. Mariana Islands v. Canadian Imperial Bank of Commerce, 21 N.Y.3d 55 (2013). None of these arguments is correct.

Contrary to Motorola's contentions, the same important policy considerations that have long supported the separate entity rule remain highly relevant in today's age of global banking.

*First*, the importance of the separate entity rule is highlighted by the existence of laws in foreign jurisdictions where international banks have branches or offices, which govern the rights in, and disposition of, assets held or accounts maintained at such branches or offices, and which in many cases provide for

serious civil and criminal sanctions in the event of breach. Applying U.S. court orders to bank accounts or assets located abroad and governed by non-U.S. account agreements and laws would enmesh international banks regularly in a web of inconsistent and irreconcilable laws and orders, as the laws of each jurisdiction where an international bank has a branch would be implicated.

The restraining notices that Motorola seeks to have given global effect would render any bank answerable in New York for <u>any</u> bank account or property entrusted to it <u>anywhere</u> in the world merely by virtue of a New York branch or office, even where the account or property in question has no U.S. connection and the local law governing the relationship between the bank and its customer affirmatively prohibits restraint or does not recognize the effectiveness of a foreign restraint to relieve the bank of local repayment liability to its customer based on the terms of a foreign order. The issuance of such orders by New York courts would be contrary to the well-established U.S. rule that the courts in the jurisdiction in which assets are actually located or accounts maintained should determine the rules regarding the treatment of assets or accounts, and would infringe on the sovereignty and primary jurisdiction of the nation in which those accounts or assets are actually located.

*Second*, absent the separate entity rule, the burdens placed on banks with New York branches or offices would be significant – in terms of cost, time,

resources, and ability to satisfy and retain customers. In addition to the cost of global searches, banks would become embroiled in inevitable conflicts among competing legal systems and parties – a multiplication of litigation that is avoidable by requiring, as has historically been the case, creditors to bring enforcement proceedings against banks in the jurisdiction where assets are held or accounts maintained.

Motorola's suggestion that the burdens imposed on international banks by overturning the separate entity rule can be avoided by having banks operate in New York through subsidiaries ignores the reasons for branch banking and the significant benefits to New York and the United States that branch banking confers. A branch's lending capacity is based on the international bank's entire capital base. A U.S. subsidiary bank would have only its much smaller capital base as a limit on its lending capacity, and accordingly, the subsidiary bank's ability to operate in New York would be greatly diminished. Adopting a rule that may discourage banks from operating in New York through branches would be detrimental to New York's status as a preeminent global banking center and to New York banking customers, and it may encourage international banks to shift their U.S. dollar deposit and loan business to branches in other states or other countries. Moreover, the use by foreign banks of subsidiaries in New York to address the problem that would be created by abandonment of the separate entity

rule would be of no help to global banks organized or headquartered in New York which, in order to compete with other global banks, use branches in other jurisdictions.

In addition to the many other policy considerations that support the separate entity rule, the rule in the transnational context is now rooted in federal constitutional doctrine. Under the Supreme Court's recent decision in Daimler AG v. Bauman, 134 S. Ct. 746 (2014), a bank incorporated and headquartered outside of New York is not subject to general jurisdiction here merely by reason of doing business through a New York branch or office, and as a result, a restraining notice served on the New York branch of such a bank does not extend to the bank generally – i.e., to branches outside of New York. In light of Daimler, overturning the separate entity rule could have the anomalous result of disadvantaging domestic banks that are "at home" in New York under Daimler and also operate outside New York by subjecting those banks alone to the burden of global post-judgment asset restraints.

Motorola's effort to dismiss the separate entity rule as the product of a few lower court cases and limited to pre-judgment attachments is belied by the case law. The courts of this state have accepted and applied the separate entity rule for literally scores of years. And although this Court has never explicitly addressed the rule, the Appellate Divisions of the First and Second Departments have treated

the rule as sanctioned by this Court, and the First Department concluded little more than a decade ago that the rule was so firmly embedded in the New York common law that it should not be overturned or reduced in scope without an explicit pronouncement from this Court or the Legislature. See Nat'l Union Fire Ins. Co. v. Advanced Employment Concepts, Inc., 269 A.D. 2d 101, 101 (1st Dep't 2000).

In applying the separate entity rule, the New York State and federal courts have long recognized that the same considerations that support the rule in the pre-judgment context apply equally in the context of post-judgment restraints, and have routinely adhered to the separate entity rule in the post-judgment enforcement context. Indeed, the New York state cases decided after this Court's decision in Koehler have uniformly found that the separate entity rule applies to Article 52 restraining notices and turnover orders.[2] There is similarly no basis for finding that the Legislature overturned (or intended to overturn) the separate entity rule when it adopted the C.P.L.R. in 1962. Under this Court's case law, where the Legislature is aware of an existing common law rule, new legislation does not repudiate the rule unless the legislation expressly so indicates. The Legislature clearly was aware of the separate entity rule in 1962, and Motorola cites no case that has adopted Motorola's novel reading of the C.P.L.R.'s enactment.

[2] The majority of, and most recent, federal cases have also found that the rule continues to apply in the post-judgment context after this court's decision in Koehler. See, e.g., Tire Eng'g, 740 F.3d at 115 n.10 (citing New York state and federal courts continuing to apply separate entity rule post-Koehler); see also SCB Br. at 59-61, 70-71.

Finally, Motorola's argument that this Court's decisions in Koehler and Northern Mariana abrogated the separate entity rule is without merit. As Motorola concedes, this Court "never mentioned" the separate entity rule in those decisions. Motorola Br. at 32. Further, neither case involved the separate entity rule, as neither case involved an attempt to reach assets or accounts at the non-New York branches of a bank via service of process on a bank's New York branch. Thus, neither case considered whether, let alone held that, merely by reason of the existence of a New York branch, a foreign bank must restrain, or turn over, assets held or accounts maintained outside of New York at the non-U.S. head office, or non-U.S. branches, of that bank in response to process issued in a New York judgment enforcement proceeding.

For all of these reasons and the reasons set forth below, this Court should answer the certified question in the affirmative.

## ARGUMENT

### I. THERE ARE SIGNIFICANT POLICY CONSIDERATIONS THAT SUPPORT THE SEPARATE ENTITY RULE AND THOSE POLICY CONSIDERATIONS APPLY WITH EQUAL FORCE IN THE CONTEXT OF POST-JUDGMENT RESTRAINTS

Important policy reasons underlie the separate entity rule.[3] These policies

[3] This Court is of course free to consider public policy in reaching its decisions, including decisions concerning the construction of New York statutes, as its recent decision in In re Thelen LLP, __ N.E.3d __, 2014 WL 2931526, at *7-8 (N.Y. July 1, 2014), confirms. In re Teachers Ins. & Annuity Ass'n of Am. v. City of N.Y., 82 N.Y.2d 35, 43 (1993) (Motorola Reply at 30), found that policy should not be used to create rules directly inconsistent with specific statutory

are not meant to "insulate[]" banks from foreign claims (Motorola Reply at 4) but rather serve the important goal of promoting New York as a financial center by encouraging banks to operate in this jurisdiction through branches. Indeed, banking is one of the few businesses that is conducted cross-border through branches. The separate entity doctrine has helped foster that development.

### A. The Separate Entity Rule Recognizes That Banks Operating Internationally Are Subject To Multiple And Frequently Conflicting Laws

#### 1. The Separate Entity Rule Allows Banks To Avoid Having To Choose Among Competing Legal Regimes

By limiting the reach of New York orders (including post-judgment restraints) affecting assets or accounts to those held or maintained at the New York branch or office, the separate entity rule serves the important policy goal of avoiding conflicts among competing legal regimes. See, e.g., Shaheen Sports, Inc. v. Asia Ins. Co., No. 98 Civ. 5951 (LAP), No. 11 Civ. 920 (LAP), 2012 WL 919664, at *8 (Mar. 14, 2012); Ayyash v. Koleilat, 38 Misc. 3d 916, 924 (N.Y. Sup. Ct. 2012), *aff'd on other grounds*, 115 A.D.3d 495 (1st Dep't 2014); Global Tech., Inc. v. Royal Bank of Can., No. 150151/2011, 2012 WL 89823, at *5 (N.Y. Sup. Ct. Jan. 11, 2012) (noting that separate entity rule was "historically justified . . . on the recognition that any banking operation in a foreign country is necessarily subject to the foreign sovereign's own laws and regulations" (citation omitted)); see

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language. The case has no bearing here, where a long-standing rule of New York common law supplements – but is not contrary to – New York statutory law.

also Clinton Trust Co. v. Campania Azucarera Central Maybay S.A., 172 Misc. 148, 151 (N.Y. Sup. Ct.), *aff'd*, 258 A.D. 780 (1st Dep't 1939); FRBNY Amaprop Amicus at 11. This respect for non-U.S. law was highlighted by the U.S. government in an amicus submission to the U.S. Supreme Court:

> In terms of international banking law, the separate entity doctrine thus gives recognition to the fact that any banking operation in a foreign country is necessarily subject to the foreign sovereign's own laws and regulations . . . .

Brief for the United States as Amicus Curiae Supporting Petitioner, Citibank, N.A. v. Wells Fargo Asia Ltd., No. 88-1260, 1989 WL 1126987, at *14 (U.S. 1989) (footnote and citation omitted). Contrary to Motorola's assertion, recognizing the significance of foreign law does not mean that "any foreign law [] takes precedence over New York law" (Motorola Reply at 42), but rather, under the doctrine of comity, provides due respect to the law of the jurisdiction *in which assets are actually located or accounts maintained* in determining whether to issue an order with respect to those assets or accounts.

Consistent with the doctrine of comity, it has long been U.S. policy to avoid applying U.S. laws in a way that interferes with the laws of other nations. See, e.g., Petersen v. Chem. Bank, 5 Tiffany 21, 32 N.Y. 21, 29 How. Pr. 240 (N.Y. 1865) (enunciating principle of comity); F. Hoffmann-La Roche Ltd. v. Empagran S.A., 542 U.S. 155, 164 (2004). A central tenet of comity is that "a state may not require a person to do an act in another state that is prohibited by the law of that

state or the law of the state of which he is a national." Motorola Credit Corp. v. Uzan, 388 F.3d 39, 60 (2d Cir. 2004) (quoting RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 441 (1987)); see also Ings v. Ferguson, 282 F.2d 149, 152 (2d Cir. 1960)).

Although it is beyond the scope of this brief to survey the laws of all other jurisdictions, there can be no dispute that efforts to restrain, or transfer to New York, foreign customer assets or funds on deposit in accounts located in every country where the bank has a branch or office would create conflicts with other jurisdictions and subject banks to criminal, civil or regulatory liability. See, e.g., Motorola Credit Corp. v. Uzan, 978 F. Supp. 2d 205, 213 (S.D.N.Y. 2013) (noting that SCB may be subject to censure, fines, or suspension or cancellation of its license for complying with U.S. court order directed to assets in the UAE); Samsun Logix Corp. v. Bank of China, No. 105262/10, 2011 WL 1844061, at *6 (N.Y. Sup. Ct. May 12, 2011) (noting that Chinese law prohibits banks from complying with an order issued by a court outside of China to disclose information about, freeze, or transfer funds from accounts in China, and that violation of such laws could expose the bank's officers and employees to sanction and civil liability); Tiffany (NJ) LLC v. Qi Andrew, 276 F.R.D. 143 (S.D.N.Y. 2011) (similar); Shaheen, 2012 WL 919664, at *7 (noting that bank had presented colorable evidence that Pakistani law prohibited turnover of assets in Pakistan); Ayyash, 38

Misc. 3d at 924 (separate entity rule avoids conflicts with competing legal systems which have "serious civil and criminal sanctions" for the breach of local law), *aff'd on other grounds* 115 A.D.3d 495 (1st Dep't 2014) (finding that "ordering compliance [with post-judgment subpoenas and restraints] raises the risk of undermining important interests of other nations by potentially conflicting with their privacy laws or regulations"); see also Trade Dev. Bank v. Cont'l Ins. Co., 469 F.2d 35, 41 (2d Cir. 1972) (bank would be subject to criminal and civil liability in Switzerland for violating Swiss bank secrecy laws); In re Union Bank of Switz., 158 Misc. 2d 222, 225 (N.Y. Sup. Ct. 1993) (same). It is hardly surprising that a foreign country would choose to regulate banks operating within its borders. Banks and bank branches operating in New York are, after all, subject to extensive New York and federal supervision and regulations.[4]

Motorola's suggestion that, rather than continue to apply the separate entity rule, courts should apply a case by case analysis every time a plaintiff seeks an extraterritorial restraint affecting assets or accounts in another jurisdiction (see,

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[4] A New York State licensed branch is supervised and regulated by both the New York State Department of Financial Services (N.Y. Banking Law §§ 200-209) and the Board of Governors of the Federal Reserve System (12 U.S.C. §§ 3105-3111). A federally licensed branch is supervised and regulated by the Office of the Comptroller of the Currency (12 U.S.C. § 3102) and the Board of Governors of the Federal Reserve System (12 U.S.C. §§ 3105-3111). The U.S. operations of large foreign banking organizations are subject to additional, enhanced prudential standards pursuant to Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Pub. L. 111-203, 124 Stat. 1423-1432), and the regulations promulgated thereunder by the Board of Governors of the Federal Reserve System (79 Fed. Reg. 17240 et seq. (March 27, 2014)), including liquidity stress testing and buffer requirements for their U.S. branches. See 12 C.F.R. § 252.157.

e.g., Motorola Br. at 25 n.14) ignores the significant burden such a system would place on, and uncertainty it would create for, international banks operating in New York. As discussed below (see pp. 25-30), international banks are frequently involved as bystanders in complex cross-border disputes among competing legal systems and parties regarding claims to assets. Without the separate entity rule, international banks would be forced to engage in costly litigation, which may include proving applicable non-U.S. law through expert submissions, each time they are faced with a judgment creditor's effort to reach assets outside of New York. Courts would be inundated with plaintiffs seeking extraterritorial restraints (and turnover orders), and would be forced to engage in an extensive analysis in issuing decisions on the reach of such orders. See also Hoffmann, 542 U.S. at 164 (finding plaintiffs' suggestion that courts consider comity on a "case by case" basis, rather than "exclude independent foreign injury cases *across the board*" was "too complex to prove workable," including because requiring courts to compare foreign law to American law routinely would result in "lengthier proceedings, appeals, and more proceedings" (emphasis added)). The result would be one which Motorola seems to caution against – "conflicting, *ad hoc* judicial determinations." Motorola Br. at 38. Thus, Motorola's suggestion only highlights why this Court should confirm that the separate entity rule remains viable and prevents the type of relief Motorola seeks.

2. The Separate Entity Rule Is Consistent With And Supported By The Local Action Doctrine

It has long been recognized that claims to property should be decided by, and under the rules of, the jurisdiction in which the asset is located. See, e.g., RESTATEMENT (SECOND) OF JUDGMENTS § 8 (1982); see also RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 195, comment d. (1971) ("Money lent by a bank or deposited in a bank is usually repayable at the bank itself or, when the bank has branches, at the branch with which the customer dealt. In the absence of an effective choice of law by the parties, the state of the applicable law in such instances will almost invariably be the state where the bank, or the particular branch thereof, is located."); Cronan v. Schilling, 100 N.Y.S.2d 474, 476 (N.Y. Sup. Ct. 1950), *aff'd*, 282 A.D. 940 (1st Dep't 1953) (under separate entity rule, "each branch of a bank is a separate entity, in no way concerned with accounts maintained by depositors in other branches or at the home office"); Parbulk II AS v. Heritage Maritime, SA, 35 Misc. 3d 235, 238 (N.Y. Sup. Ct. 2011) ("situs of an account is fixed at the branch where the account is carried"). This position was echoed by the FRBNY in a recent New York judgment enforcement case. See FRBNY Samsun Amicus Brief at 6 (citing the "generally recognized principle [that] claims against a single asset should be decided in a single forum, and that forum should be the court of the jurisdiction in which the asset is located"). This local action doctrine avoids the specter of conflicting orders from multiple

jurisdictions as to the rights in, or disposition of, a single asset – a potential that poses particularly acute problems for banks operating in multiple jurisdictions. The principle provides a strong justification for the separate entity rule, and is a consideration raised every time a court attempts to adjudicate with respect to assets located outside of its jurisdiction.

The doctrine also reflects the fundamental role that the interests of local creditors and the public policy of the sovereign where the asset is located play in deciding how assets will be treated. New York (and other U.S.) courts have historically been willing to give effect to orders of foreign tribunals with respect to assets located here *only* if doing so would not prejudice the rights of local creditors or violate New York (or U.S.) public policy. See, e.g., In re Waite, 99 N.Y. 433, 448 (1885); see also Disconto Gesellschaft v. Umbreit, 208 U.S. 570, 579-580 (1908); Clarkson Co. v. Shaheen, 544 F.2d 624, 629 (2d Cir. 1976). Consistent with these principles, it is not logical or fair for U.S. courts to issue orders concerning assets in another jurisdiction, particularly where compliance in the foreign jurisdiction would require a third-party to violate the law and public policy of that jurisdiction. The separate entity rule avoids this problem by providing due respect for the sovereignty of other nations with primary jurisdiction over assets located within their territory.

3. Limiting The Reach Of A Post-Judgment Asset Restraint In A Manner Consistent With The Separate Entity Rule Is Consistent With The Presumption Against Extraterritorial Application Of New York Statutes

In Global Reinsurance Corp. v. Equitas Ltd., 18 N.Y.3d 722, 735 (2012), decided two years after Koehler, this Court confirmed that "[t]he established presumption is . . . against the extraterritorial operation of New York law." That presumption, which is in accord with the parallel federal law presumption against extraterritorial application of U.S. statutory law, is supported by the desirability of avoiding "clashes between our laws and those of other nations" reflected in principles of comity. Kiobel v. Royal Dutch Petroleum Co., 133 S. Ct. 1659, 1664 (2013); see also Morrison v. Nat'l Australia Bank, Ltd., 130 S. Ct. 2869, 2877 (2010). As the Supreme Court explained in its earlier decision in Hoffmann, "this Court ordinarily construes ambiguous statutes to avoid unreasonable interference with other nations' sovereign authority . . . . This rule of statutory construction cautions courts to assume that legislators take account of the legitimate sovereign interests of other nations when they write American laws. It thereby helps the potentially conflicting laws of different nations work together in harmony – a harmony particularly needed in today's highly interdependent commercial world." 542 U.S. at 156, 164-65.

The concerns that underlie these established rules of construction militate against applying an Article 52 restraint to foreign branches of international banks,

where conflicts with foreign law are practically inevitable.[5] The continued use of the separate entity rule furthers the goal of avoiding conflicts between New York law and the laws of other nations.

Motorola's reliance on the alleged existence of personal jurisdiction over SCB as a whole as the predicate for extending the reach of post-judgment restraints to non-U.S. branches of the bank (Motorola Br. at 4, 17-18; 27-28; Motorola Reply at 13-14) does not call for any different conclusion. The Supreme Court in Daimler, relying on the same concerns about the expansive reach of U.S. law and jurisdiction that support the general presumption against extraterritorial application of U.S. and New York law, held that the continuous conduct of business through a U.S. office cannot alone support the assertion of general jurisdiction over a foreign entity created and headquartered abroad. 134 S. Ct. at 761. Consequently, as discussed below, absent extraordinary circumstances not alleged to exist here, there is no constitutionally permissible basis for subjecting SCB (or other global banks) to the jurisdiction of a court sitting in New York as to assets held or

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[5] Section 5222 contains no language indicating that it was intended to apply extraterritorially. Although this Court in Koehler declined to "infer" a territorial limit on Article 52 (12 N.Y.2d at 539), this Court did not address the use of an Article 52 enforcement device against a foreign branch of an international bank subject to conflicting legal duties in foreign jurisdictions. Indeed there was no suggestion in Koehler that the laws of any other nation imposed any constraint on the turnover of the assets there at issue. See *infra* pp. 56-57. Particularly in light of this Court's subsequent decision in Global Reinsurance, Koehler should not be read to support the unlimited extraterritorial application urged by Motorola.

accounts maintained at a branch located abroad merely by reason of the existence of New York offices or branches.

#### 4. Overturning The Separate Entity Rule Would Subject Banks To The Risk Of Double Liability

A post-judgment restraint is an enforcement mechanism that is normally a predicate for an application for a turnover order requiring delivery of the amount on deposit in an account or other assets to the judgment creditor. Motorola itself makes clear that it believes it would be entitled to a turnover order if the separate entity rule is found not to apply. Motorola Reply at 38. Moreover, an asset restraint that imposes restrictions on the foreign branch of a bank from taking action with respect to assets held or accounts maintained at the foreign branch – particularly where such restraint violates the laws of the local jurisdiction – has a practical effect not dissimilar from a turnover order and, like a turnover order, can subject the bank to the risk of multiple exposure.

If a bank is prohibited by a New York restraint from transferring assets or paying deposits in another country but, according to the law of the jurisdiction where the assets or deposits are located, has to allow its customer to withdraw the assets, the bank could be liable for the assets twice.[6] It can be liable here for

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[6] Indeed, a number of foreign jurisdictions will refuse to give effect to a judgment from another country if that judgment relates to the disposition of property located outside the territorial jurisdiction of the court issuing the judgment. See, e.g., FOREIGN JUDGMENT ACT 1991, § 7(3)(b) (Austl.) ("[T]he courts of the country of the original court are taken to have had jurisdiction . . . if the property in question was . . . situated in the country of that court"); A.I.R.

contempt if it allows a customer to withdraw funds abroad, as required by the jurisdiction where the account is located, and, if it honors the restraint and refuses to allow a withdrawal, it can be liable to the customer in the foreign jurisdiction for the full amount of the account balance or, at the very least, for the loss of use of the funds while the restraint is in effect. See, e.g., Shaheen, 2012 WL 919664, at *8 (recognizing this point); Samsun, 2011 WL 1844061, at *5 (same).

As the FRBNY recently made clear to the Second Circuit in the context of another separate entity rule case, the separate entity rule protects non-party banks from double liability. See FRBNY Amaprop Amicus at 9-11 (noting that without the separate entity rule, "U.S. courts have no way to systematically discern whether creditors apart from Amaprop are seeking to enforce a judgment against the same asset through the Indian (or other) judicial system(s). The result is chaos, with multiple judgment creditors each asserting superior ownership to a single asset"). The FRBNY cautioned that a system which would create a "significant risk that [a garnishee bank] will become twice liable for [a debtor's] judgment debt" in turn creates "a perverse incentive for foreign judgment debtors to default on their debt, thus transforming New York branches of foreign banks into *de facto* insurance

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1963 S.C. 1 (India) ("A court of a foreign country has jurisdiction to deliver a judgment in rem which may be enforced or recognised in an Indian Court, provided that the subject matter of the action is property . . . within the foreign country"); Charles Platto & William G. Horton, ENFORCEMENT OF FOREIGN JUDGMENTS WORLDWIDE, 99 (2d ed. Int'l Bar Assoc. 1993) (Canadian court will enforce foreign judgment determining status of property if property was situated within the territorial jurisdiction of foreign court).

policies for judgment debtors." Id. at 10. Repudiating the separate entity rule, therefore, creates the risk that non-parties having nothing to do with the dispute (e.g., banks), will ultimately bear the cost of the judgment – judgment creditors would be allowed to collect their judgments from non-party banks, while judgment debtors would have a right to be made whole (again, by the banks).[7]

This is just the type of problem New York law seeks to avoid by insulating third-party garnishees from double liability. C.P.L.R. §5209, which provides that once a garnishee turns over property of a judgment debtor under an execution or order, the garnishee is discharged from its obligations to the judgment debtor,[8] reveals the strong New York policy that garnishee banks not be exposed to double liability. But, as the cases have found, there is no assurance that the discharge

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[7] The strong policies favoring the separate entity rule, which have been given repeated voice by the FRBNY in amicus briefs cited and discussed above, have also led to the adoption of the separate entity rule in federal regulations. Federal Reserve regulations specifically adopt the separate entity rule for purposes of check collection (12 C.F.R. §210.2(d) ("A branch or separate office of a bank is a separate bank to the extent provided in the Uniform Commercial Code")) and wire transfers (12 C.F.R. § 210.25(b)). Similarly, for purposes of determining whether a bank is "located" in the United States, and hence subject to proprietary trading restrictions under the Volcker Rule, federal regulations implementing the Volcker Rule provide that: "For purposes of paragraph (e) of this section, a U.S. branch, agency, or subsidiary of a foreign banking entity is considered to be located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary." See 79 Fed. Reg. 5536, 5786 (Jan. 31, 2014) (§ 75.6(e)(5) of the final rules) (emphasis added). SEC regulations also treat local agencies or branches as separate and distinct from the other branches and offices of a foreign bank. See 17 C.F.R. § 230.902(k) (defining "U.S. person" to include "[a]ny agency or branch of a foreign entity located in the United States").

[8] "A person who, pursuant to an execution or [turnover] order, pays or delivers, to the judgment creditor . . . money or other personal property in which a judgment debtor has or will have an interest, or so pays a debt he owes the judgment debtor, *is discharged from his obligation to the judgment debtor to the extent of the payment or delivery.*" C.P.L.R. § 5209 (emphasis added).

contemplated by Section 5209 will be given effect abroad where assets may be located. Shaheen, 2012 WL 919664, at *8 ("Moreover, HBL argues that were it required to turn over Asia Insurance assets in New York, this would not discharge its obligations to Asia Insurance in Pakistan, because Pakistan's courts do not recognize judgments in U.S. courts. HBL's concern for potential inconsistent judgments and double liability is therefore very real"); Samsun, 2011 WL 1844061, at *6 (finding that banks were subjected to risk of double liability where New York court restraint and turnover order would not be recognized in China). Granting Motorola a post-judgment restraint (and turnover) would create the very risk of double liability that New York law seeks to avoid. Simply put, this Court cannot provide any "assurance that [SCB] will not be held liable again in another jurisdiction." W. Union Tel. Co. v. Pennsylvania, 368 U.S. 71, 75 (1961).

The Supreme Court has long recognized that double liability raises concerns of a constitutional nature. Harris v. Balk, 198 U.S. 215, 226 (1905) ("It ought to be and it is the object of courts to prevent the payment of any debt twice over"). As Justice Kent wrote nearly a century before Harris, "[n]othing can be more clearly just, than that a person who has been compelled, by a competent jurisdiction, to pay a debt once, should not be compelled to pay it over again." Embree v. Hanna, 5 Johns 101, 102 (1809). Applying that principle, the Supreme Court warned that, even where the court has *in rem* jurisdiction, "the holder of

such property is deprived of due process of law if he is compelled to relinquish it without assurance that he will not be held liable again in another jurisdiction or in a suit brought by a claimant who is not bound by the first judgment." W. Union, 368 U.S. at 75 (citing Anderson Nat'l Bank v. Luckett, 321 U.S. 233, 242-43 (1944); Sec. Savs. Bank v. California, 263 U.S. 282, 286-90 (1923)).

New York courts have found that, where a turnover order creates the potential for double liability, this would be "an unconscionable result." Oppenheimer v. Dresdner Bank A.G., 50 A.D.2d 434, 441 (2d Dep't 1975); see also JPMorgan Chase Bank, N.A. v. Motorola, Inc., 47 A.D.3d 293. 300-302, 306 (1st Dep't 2007) (citation omitted) (rejecting turnover because of risk of double liability: "[T]he record evidence indicates that the Indian courts will not give the judgment appealed from the effect to which it is entitled under New York law"); Samsun, 2011 WL 1844061, at *5. The separate entity rule prevents the very risk of double liability which the C.P.L.R. is designed to avoid.

Despite Motorola's contention, there is no requirement (and there should not be one) that liability be "certain" for the policy against double liability to come into play. Motorola Reply at 36. The reality in the context of foreign banking is that there is a very significant risk of double liability for any bank operating in New York and in another jurisdiction that will not recognize the Section 5209 discharge. Although SCB or other banks would be "afforded the benefit" of

Section 5209 (Motorola Reply at 36) when turning over customer assets located in New York or even in another U.S. state, that "benefit" is meaningless in another jurisdiction that does not recognize a New York court order requiring the bank to pay over funds on deposit in an account maintained at a branch located in that jurisdiction to a judgment creditor. As the FRBNY cautioned, if the separate entity rule is ignored, and banks are faced with a "significant risk" of double liability, "[t]his will cause foreign banks to reassess their risk exposure and the associated cost of doing business in New York (if they choose to even maintain a New York presence). Ultimately, the cost of this risk will likely be borne by the consumer in the form of increased banking fees." FRBNY Amaprop Amicus at 10.

Finally, international banks such as SCB do not somehow accept the risk of double liability by doing business in New York. Motorola Reply at 39. As SCB points out in its brief, the New York Legislature has rejected that proposition.[9] The

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[9] In response to the so-called Petrogradsky line of cases, which addressed the risks of double payment by banks where the banks are subject to conflicting claims of multiple parties claiming a direct ownership interest in an account, the Legislature enacted laws specifically designed to protect international banks from the threat of double liability, negating any suggestion that New York "as a matter of law . . . places on banks any risk" of double liability. Compare SCB Brief at 27-32 with Motorola Reply at 3.

Moreover, in JPMorgan the First Department reviewed the Petrogradsky line of cases and distinguished these cases on the ground that they involved situations where a party asserted an ownership right to a bank account, and refused to follow them in the context of third-party garnishment proceedings: "Further, Chase, the party asking us to expose Motorola to the risk of double liability, seeks to garnish an asset to which Chase (unlike the plaintiffs in the *Petrogradsky* line of cases) asserts no claim in its own right, but only a derivative claim as judgment creditor of an absent third party." JPMorgan, 47 A.D.3d at 311. Motorola, like the losing plaintiff in JPMorgan, seeks to use garnishment to obtain assets located outside of the jurisdiction, to which Motorola asserts no direct right.

separate entity rule protects international banks from exposure to worldwide liability arising from the application of New York pre-judgment attachments and post-judgment enforcement devices. A bank such as SCB would have no reason to think that by operating in New York through a branch it would be open to worldwide liability particularly where, as SCB highlights, the separate entity rule has been in place in New York (and elsewhere) for scores of years.[10] See SCB Br. at 19-39; 82-88.

### B. International Banks Would Be Unduly Burdened If Required To Address Global Asset Restraints Issued In New York Proceedings

Historically, the separate entity rule also recognized that requiring any branch other than the branch at which an account is located to handle an order relating to that account would place "an intolerable burden upon banking and commerce." Cronan, 100 N.Y.S.2d at 476, *aff'd*, 282 A.D. 940. Far from being rendered "obsolete" by the advent of computers and the internet (Motorola Br. at 38; Motorola Reply at 31), this consideration remains an important one, and has been recognized as such in recent cases. For example, the FRBNY recently

[10] As SCB outlines in great detail in its brief, the separate entity rule arose specifically because of New York's prominence as an international financial center. See SCB Br. at 65. That some states are "silent" on the issue of the separate entity rule or have issued orders with respect to assets in other U.S. states (see Motorola Reply at 46, n.38) ignores New York's prominent status as an international banking center. Motorola Reply at 45. States like New Jersey, Connecticut and Pennsylvania simply do not have the same level of international bank presence.

recognized in Samsun that the burden concern remains relevant in the context of world-wide post-judgment restraint and garnishment orders:

> It's not uncommon for many banks to still rely on paper records. Even when records are electronic, many banks rely on different computer platforms. . . . It's [searching for records] a huge undertaking, and [if required to respond to such orders] banks will also become routine players in costly and complicated international lawsuits . . . .

Transcript of Oral Argument at 75-6, Samsun, Index No. 105262/2010 (Feb. 4, 2011).

These concerns are equally present here. When served with a subpoena, restraint or turnover order directed to assets or deposits abroad, the New York offices of global banks often lack the practical access to information or accounts located at non-U.S. branches. See, e.g., Tiffany, 276 F.R.D. at 152 (noting that information sought "is located abroad and cannot be accessed by personnel" at the non-party Chinese banks); Samsun, 2011 WL 1844061, at *6 (banks filed affidavits showing "that the computer systems in the New York branches of the Banks do not provide access to customer account information at the head office or at branches outside of the United States"). Thus, the rationale Motorola asserts originally underpinned the separate entity rule – that banks at one branch had no effective way "to ascertain the status of a debtor's account at another branch" – retains vitality. Motorola Br. at 35. Not only has this rationale not become irrelevant (Motorola Reply at 31), but the case Motorola claims began to erode this

premise (id. at 32, citing Digitrex, Inc. v. Johnson, 491 F. Supp. 66, 68 (S.D.N.Y. 1980)), has been expressly *limited*, including by cases cited by Motorola.

In John Wiley & Sons, Inc. v. Kirtsaeng, No. 08 Civ. 7834, 2009 WL 3003242, at *4 (S.D.N.Y. Sept. 15, 2009) (Motorola Br. at 37, n.22), the court found that the "Digitrex exception" is *only* applicable where: "(1) the restraining notice is served on the bank's main office; (2) the bank's main office and branches [where the accounts in question are maintained] are within the same jurisdiction; and (3) the bank branches are connected to the main office by high-speed computers and are under the centralized control of the main office." Id. (citations omitted); see also Nat'l Union, 269 A.D.2d at 101.[11] Recognizing these limitations, New York courts have recently found that the practical inability of New York branch banks to address global asset restraints and turnover orders continues to be a compelling reason to employ the separate entity rule. See, e.g., Samsun, 2011 WL 1844061, at *4; see also Lok Prakashan Ltd. v. India Abroad Publ's, Inc., No. 00 Civ. 5852, 2002 WL 1585820, at *1 (S.D.N.Y. July 16, 2002).

[11] Zemo Leasing Corp. v. Bank of N.Y., 158 Misc. 2d 991, 991 (N.Y. Sup. Ct. 1993), and S&S Mach. Corp. v. Mfrs. Hanover Trust Co., 219 A.D.2d 249, 251-253 (1st Dep't 1996) (Motorola Br. at 39; Motorola Reply at 32-33), do not assist Motorola. There is no suggestion in Zemo that the restraint involved was directed at accounts outside of New York. 158 Misc. 2d at 992-993. S&S Machinery found that a restraining notice and subpoena served on a bank's main office in Manhattan operated to require discovery of information about and restraint of assets located at the bank's corporate trust department, located just a few blocks away from the main office. 219 A.D.2d at 251-253. Again, the case did not in any way involve an extraterritorial asset restraint.

Even if a bank's New York office or branch could access information abroad,[12] and the bank were not prohibited under the law of the jurisdiction where the accounts are located from providing that information to its New York office or branch for disclosure in a New York court proceeding, such requests would still be unduly burdensome and costly not only in terms of money, but in terms of time, resources, and customer relationships. As the district court below noted, "it is clear that the policies implicated by abolition of the separate entity rule run much deeper than the ability to communicate across branches." Motorola, 978 F. Supp. 2d at 213.

*First,* as recognized by the FRBNY, extraterritorial restraints like that sought by Motorola would compel banks to search the entire worldwide organization to determine whether property belonging to the judgment debtor could be found at any branch anywhere in the world, and take the steps necessary to freeze (and possibly transfer to New York) that property. This will impose substantial costs and risks on banks merely because they have New York operations. This reality has recently been evidenced in the context of federal maritime enforcement procedures. See Cala Rosa Marine Co. v. Sucres Et Deneres Grp., 613 F. Supp. 2d 426, 431 n.37 (S.D.N.Y. 2009). As a result of the Second Circuit's adoption of a

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[12] To the extent Motorola suggests that policies regarding burden are applicable only to discovery and not restraint (Motorola Reply at 34), that argument ignores the fact that in order to restrain (and eventually turnover) assets, banks would have to first search for them.

new and expansive interpretation of the federal maritime attachment rule, there was a surge in maritime attachment requests, which resulted in "New York banks . . . hir[ing] additional staff, and suffer[ing] considerable expenses, to process the attachments," including because "each attachment requires banks to amend 'their software screens.'" Id. The massive increase in the use of maritime enforcement procedures following the adoption of the new interpretation led the Second Circuit to reconsider and abandon this approach. See Shipping Corp. of India v. Jaldhi Overseas PTE Ltd., 585 F.3d 58, 61 (2d Cir. 2009).

*Second,* banks with New York branches or offices would be forced, at their own expense, to become frequent participants in complex cross-border legal disputes, as the FRBNY has made clear in its two recent *amicus* submissions addressing the impact of Koehler. See FRBNY Samsun Amicus at 5 and FRBNY Amaprop Amicus at 11, discussed above at pp. 15, 20-21, 24-26. In addition to dedicating resources both here and abroad to defending suits, and filing briefs and affidavits, banks would be forced to insure against this litigation risk and recover the costs from customers – all of which would disrupt, and increase the cost of, banking services around the world.

*Third*, as the FRBNY further cautioned, were a New York court to enter an order directed to assets or deposits held abroad at foreign banks, other jurisdictions and countries might follow New York's example, and enter orders affecting U.S.

bank accounts. See FRBNY Samsun Amicus at 7. This web of reciprocal laws, by which courts around the world might begin entering orders affecting assets outside of their jurisdictions, would further expand the burden on international banks and, in the FRBNY's words, "ultimately threaten[] the balance of international banking law." Id.[13] Particularly because New York courts have long been a reference point for other jurisdictions on banking issues,[14] the expansive exercise of extraterritorial power advocated here might be followed by courts in other nations to the detriment of international banks and New York's status as an international banking center.

What is anomalous about all this is that garnishee banks historically protected by the separate entity rule are mere bystanders to myriad underlying legal disputes. There is no unfairness in imposing on judgment creditors the costs of proper enforcement in the jurisdiction where assets or deposits are located, and refusing to allow those costs to be shifted to banks whose only act was opening a New York branch or office.

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[13] Indeed, such concerns also have been echoed by commentators, who have observed that ordering foreign banks to deliver assets into the United States "might expose U.S. banks to similar rulings abroad, with severe effects, since it would tilt what has been a level playing field against foreign banks." Clyde Mitchell, *Separate Entity Rule – U.S. Branches of Non-U.S. Banks,* N.Y.L.J. 3, col. 1 (Nov. 18, 1998).

[14] See, e.g., Unicredito Italiano v. JPMorgan Chase Bank, No. 2-104, 2002 WL 1378226, at *4 (D. Del. June 26, 2002) (transferring case on ethics in banking profession to New York because "[w]ith deference to Delaware's significant role in the banking industry, New York City remains the financial center of the United States, if not the world"); Int'l Multifoods Corp. v. Commercial Union Ins. Co., 98 F. Supp. 2d 498, 502 (S.D.N.Y. 2000) ("New York is a leading center of banking, commerce and insurance in the United States, and the law developed by its courts is generally recognized and respected in such a light").

### C. The Separate Entity Rule Encourages Banks To Operate In New York Through Branches, Which Is Important To The New York And U.S. Economies

Motorola repeatedly suggests that SCB would be better off if it operated in New York through a subsidiary rather than a branch, suggesting that SCB chose to operate in New York "as a unitary bank" for its own selfish reasons. See, e.g., Motorola Reply at 40. What Motorola ignores however, is that it is the New York economy and New York bank customers that actually benefit from banks operating as "unitary" banks rather than through separately incorporated subsidiaries. Indeed, Motorola's argument flies in the face of New York policy – including as articulated by the Legislature (see *infra* p. 34) – in favor of having banks operate in New York through branches, and highlights why the separate entity rule is so important to New York and its economy.

There are significant economic reasons that favor use of branches rather than bank subsidiaries by non-U.S. and U.S. banks. A depositor or other creditor of a U.S. branch of a non-U.S. bank has the worldwide capital of the bank behind an obligation, not merely that of a local subsidiary. See Report of the Superintendent's Advisory Committee on Transnational Banking Institutions (Mar. 1992) ("Superintendent's Report") at 9 (AMI-ADD-162). In addition, the maximum size of a loan to any one borrower of a U.S. branch of a non-U.S. bank is determined on the basis of the regulatory capital of the non-U.S. bank as a whole

(12 U.S.C. § 3102(b)(1); N.Y. Banking Law § 202-f) as opposed to the lending limits of a U.S. bank subsidiary, which are determined by the regulatory capital of the U.S. bank subsidiary alone. 12 U.S.C. § 84; N.Y. Banking Law § 103. Hence, a non-U.S. bank branch can make larger and more loans in the United States than it could through a subsidiary bank. For this reason, "[t]he ability of foreign banks to do business through branches and agencies is . . . important to New York and its economy." See Superintendent's Report at 9 (AMI-ADD-162) ("The Committee further believes that the greater access to international credit markets that the branch/agency form affords to businesses in the United States is beneficial to the American economy as a whole").

The Superintendent's Report's determination that the ability of foreign banks to do business in New York through branches is beneficial was echoed by the Secretary of the Treasury and Board of Governors of the Federal Reserve System in a study (conducted in consultation with the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Attorney General) to determine whether foreign banks should be required to conduct banking operations in the U.S. through subsidiaries rather than branches. The Treasury and Board of Governors concluded that such a requirement should not be imposed (and indeed indicated that they would "oppose" such a requirement), including because a branch of a foreign bank is able to operate more efficiently than a separate

subsidiary of a foreign bank, due to a number of factors, including, the "ability to deploy capital flexibly" and "the ability to compete based on access to the worldwide capital base of its parent." See Department of the Treasury and Board of Governors Subsidiary Requirement Study (Dec. 1992) ("Subsidiary Study") at 1, 4 (AMI-ADD-002, 005). The Treasury and Board of Governors further found that "branch operations of foreign banks provide numerous economic and financial advantages to consumers and financial institutions in the United States and abroad" (id. at 15) and concluded that requiring banks to operate through subsidiaries could reduce "the availability of credit in the United States market . . . perhaps substantially." Id. at 2, 22-23 (AMI-ADD-003, 023-024); see also id. at 6 (AMI-ADD-007) (further noting that the "growth in foreign bank activities in the United States has added to the liquidity of the U.S. market while deepening the availability of credit to borrowers").[15]

The same principles govern the decision of U.S. banks to open branches outside the U.S., as those branches take advantage of the worldwide capital of the banks. Superintendent's Report at 10-11 (AMI-ADD-163). When the New York Legislature unanimously enacted legislation which shielded banks located in New

[15] As noted above (see p. 13, n.4), the Board of Governors recently adopted a final rule pursuant to Section 165 of the Dodd-Frank Act, 12 U.S.C. § 5365, imposing enhanced prudential standards on foreign banking organizations operating in the United States. The final rule confirmed the ability of foreign banks to continue to conduct banking activities in the United States through branches, and to do so on the basis of the foreign bank's total capital, though subject to new branch liquidity requirements. See 79 Fed. Reg. 17240 (Mar. 27, 2014).

York "from claims of depositors in their foreign branches," the sponsor of the legislation made clear that the legislation was intended to "maintain[] the option of using the branch structure in foreign countries – *this structure is more cost-efficient than a separate subsidiary and enables U.S. banks to remain competitive with foreign banks*." Bill Jacket, L. 1994, ch. 264, at 7, 8 (SCB-ADD-123) (emphasis added). The Treasury and Board of Governors in their 1992 study similarly noted the importance of the ability of U.S. banks to operate through branches abroad, and expressed the concern that, if the U.S. required foreign banks to operate through subsidiaries, "[f]oreign countries might [] retaliate against U.S. bank branches, perhaps by requiring that they establish a subsidiary." Subsidiary Study at 2 (AMI-ADD-003).

The separate entity rule facilitates and encourages use of the branch form. Abandonment or constriction of the rule would impose significant burdens on international banks operating in New York and could influence non-U.S. banks to conduct their New York banking operations through subsidiaries rather than branches or to conduct U.S. dollar business at locations outside New York or the United States.[16] This would damage New York's status as a preeminent

[16] That international banking in New York has not "collapsed" since Koehler (discussed below), which Motorola contends repudiated the separate entity rule in the context of judgment enforcement proceedings, does not mean that foreign and domestic banks will continue to do business in New York no matter what the circumstances. Motorola Reply at 12, n.5. Despite initial concerns about Koehler's impact, every New York state court and the majority of, and most recent, federal courts considering the issue concluded that Koehler did not abrogate the

international financial center by having "a significant adverse impact on the international banking business done in the United States and could result in the withdrawal of capital from U.S. markets." Superintendent's Report at 11.[17]

## II. DAIMLER HIGHLIGHTS THE APPROPRIATENESS AND IMPORTANCE OF THE SEPARATE ENTITY RULE, PARTICULARLY FOR BANKS HEADQUARTERED OR INCORPORATED IN NEW YORK

### A. Under Daimler, International Banks Incorporated And Headquartered Outside Of New York Are Not Subject To General Jurisdiction Here

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separate entity rule. See, e.g., Tire Eng'g, 740 F.3d at 115 n.10 (citing New York state and federal courts continuing to apply separate entity rule post-Koehler); see also SCB Br. at 59-61, 70-71. A decision by this Court finding that the separate entity rule is not viable, however, may well have the effect of influencing banks operating in New York to reassess whether they want to continue to do business here as branches, where doing so will open them up to multiple and competing global enforcement orders. In addition, it would pose a strong barrier to entry into the New York banking market by foreign banks seeking to establish *de novo* branch operations in the United States, with the prospect that such banks would decide to establish branches in a state other than New York.

[17] Abuhamda v. Abuhamda, 236 A.D.2d 290, 290 (1st Dep't 1997), a case which involved a pre-judgment injunction, does not support Motorola's argument that the separate entity rule is somehow not necessary for New York to be competitive. Motorola Reply at 45. Abuhamda, a one paragraph decision, involved a pre-judgment asset freeze – not a post-judgment restraint – and did not address the separate entity rule. 236 A.D.2d at 290. Any suggestion that Abuhamda reflects a general rule that a court may issue a pre-judgment global asset restraint that applies to assets in a bank account located at a foreign bank branch to secure a money judgment has been put to rest by this Court's decision in Credit Agricole Indosuez v. Rossiyskiy Kredit Bank, 94 N.Y.2d 541, 548 (2000), which held that there is a "settled proscription against preliminary injunctions merely to preserve a fund for eventual execution of judgment in suits for money damages" (i.e., that a plaintiff seeking money cannot obtain a pre-judgment restraint in *any* circumstances, let alone one that extends extraterritorially). For the same reason, the dicta in Global Tech., 2012 WL 89823, at *5, citing Abuhamda, does not support a conclusion that New York courts would permit an extraterritorial pre-judgment asset restraint directed to a non-party bank. The court in Global Tech. applied the separate entity rule in the context of a post-judgment restraint. Id. at *3.

1. Daimler Sets Forth A General Rule That Entities Are Only Subject To Jurisdiction In The Fora Where They Are Incorporated Or Have Their Principal Place Of Business

In its recent decision in Daimler AG v. Bauman, 134 S. Ct. 746 (2014), the Supreme Court fundamentally altered the contours of general jurisdiction in U.S. courts, articulating a narrow view of general jurisdiction for international entities. Under Daimler, there is no general jurisdiction in New York over banks which are not incorporated in and do not have their principal place of business in New York.

In Daimler, the Court held that a corporation is not subject to general jurisdiction merely because it "'engages in a substantial, continuous, and systematic course of business'" in the forum, including through an agent or affiliate. 134 S. Ct. at 761. A corporation is only subject to general jurisdiction where it is considered "at home" and there are "only a limited set of affiliations with a forum [that] will render a defendant amenable to all-purpose jurisdiction there." Id. Absent exceptional circumstances, a company only is "at home" where the corporation is incorporated or has its principal place of business. Id.

The Court also found that, for purposes of determining where a corporation is subject to general jurisdiction, a court should look at the corporation's worldwide activities and contacts. Notably, in Daimler, where the Court assumed that the activities of Daimler's subsidiary could be attributed to the parent (134 S. Ct. at 760), the Court found that the presence of multiple offices in California and

sales in California amounting to nearly 2.5% of Daimler's global sales did not support general jurisdiction.

The Supreme Court's holding specifically rejected older authority that held that the courts of New York had general jurisdiction over foreign corporations that "engage[d] in a substantial, continuous, and systematic course of doing business" in New York, including by doing business in the state through a local office. Id. at 761, n.18 (these decisions "should not attract heavy reliance today") (citing Barrow S.S. Co. v. Kane, 170 U.S. 100 (1898), and Tauza v. Susquehanna Coal Co., 220 N.Y. 259 (1917) (Cardozo, J.)). Both Barrow and Tauza found general jurisdiction based on maintenance of an office here, and both – and in particular Tauza – had long been cited as support for the well-accepted pre-Daimler rule that doing business through an office in New York subjects a corporation to general personal jurisdiction in New York. See, e.g., Hoffritz for Cutlery, Inc. v. Amajac, Ltd., 763 F.2d 55, 57-58 (2d Cir. 1985) (citing Tauza); Landoil Resources Corp. v. Alexander & Alexander Services, Inc., 77 N.Y.2d 28, 33-34 (1990) (same). By specifically identifying and repudiating those cases, Daimler made clear that it was also repudiating that previously well-established rule.

Daimler has fundamentally altered the contours of general jurisdiction in New York (and other states). See also Daimler, 134 S. Ct. at 770. (Sotomayor, J., concurring) (referencing the "new rule" announced by the majority, and noting that

the majority had rejected "the 'continuous and systematic' contacts inquiry that has been taught to generations of first-year law students"). The unmistakable import of Daimler is to overturn the long line of cases that had held that an international bank was subject to general jurisdiction here by reason of its New York branch. See, e.g., Dietrich v. Bauer, No. 95 Civ. 7051 (RWS), 2000 WL 1171132, *4 n.4 (S.D.N.Y. Aug. 16, 2000) (rejecting as "manifestly incorrect" an argument that a foreign bank with a New York branch was not "doing business" in New York). Those cases in turn rested on the even longer line of cases finding doing business jurisdiction over business corporations based on the conduct of business in New York, noted above. See, e.g., Hoffritz, 763 F.2d at 57-58 (citing, *inter alia*, Frummer v. Hilton Hotels Int'l, Inc., 227 N.E.2d 851 (N.Y. 1967)). As a result banks such as SCB, which are organized under the laws of and headquartered in other jurisdictions, and whose New York branches represent only one of hundreds, or in some cases, thousands of branches, the vast majority of which are located abroad, are not subject to general jurisdiction in New York.

2. The Comity Considerations Highlighted In Daimler Also Support Limiting The Jurisdictional Reach Of U.S. Courts

The Court in Daimler also emphasized that the "risks to international comity posed" by expansive notions of personal jurisdiction were relevant in determining whether the exercise of jurisdiction met the "fair play and substantial justice" demands of due process. Daimler, 134 S. Ct. at 763. Daimler made clear that

these considerations of international comity require, especially in the transnational context, a restrained approach to personal jurisdiction. Daimler, 134 S. Ct. at 763.

### B. Daimler Is Directly Relevant To This Appeal And The Certified Question

Contrary to Motorola's contention, Daimler is directly relevant to the certified question here. Motorola Reply at 14. As the Second Circuit recognized in certifying this question (and as Motorola repeatedly emphasizes), this Court "explained in *Koehler* [that] 'article 52 postjudgment enforcement involves a proceeding against a person – its purpose is to demand that a person convert property to money for payment to a creditor.' . . . Accordingly, 'personal jurisdiction is the linchpin of authority under 5225(b).'" Tire Eng'g, 740 F.3d at 110-111 (citing and quoting Koehler and N. Mariana and noting that separate entity rule applies "even if a bank is subject to personal jurisdiction due to the presence of a New York branch"); see also Motorola Br. at 17-18, 27-28; Motorola Reply at 45 (personal jurisdiction is the "'linchpin' in the context of post-judgment enforcement"); Motorola Reply at 13-14 ("[A] New York Court's post-judgment enforcement powers are defined by its jurisdictional reach"). Daimler holds that, for due process purposes, entities which are neither incorporated nor headquartered in a New York forum are not, absent exceptional circumstances, subject to general jurisdiction in New York, i.e. even where such entities conduct banking business through an office here. Daimler thus establishes that such banks ordinarily cannot

be subject to extraterritorial asset restraint or turnover orders of the type Motorola seeks here – the same result achieved through application of the separate entity rule. 134 S. Ct. at 761. Daimler has, in effect, elevated the separate entity rule to a rule of constitutional dimension as to banks incorporated and headquartered abroad.

Motorola acknowledges, repeatedly, that there must be personal jurisdiction over a bank in order for it to be subject to a post-judgment asset restraint issued by a New York court, and that Daimler addressed "the limits on personal jurisdiction imposed by the Due Process Clause of the U.S. Constitution." Motorola Reply at 14. Nonetheless, Motorola argues that SCB is subject to personal jurisdiction by reason of SCB's establishment of a branch and "conduct of business in New York." Motorola Reply at 14, 15. That position cannot be squared with Daimler, which explicitly rejects the argument that an entity is subject to personal jurisdiction in every forum in which it "do[es] business." 134 S. Ct. at 761, n.18.[18]

[18] Motorola's other efforts to distinguish Daimler also fail. Daimler is not "inapposite" because it involved a proceeding seeking to assert jurisdiction over a parent based on the presence of a subsidiary. Motorola Reply at 16. The court in Daimler assumed that the actions of the subsidiary could be imputed to the parent, but still found a lack of personal jurisdiction because the parent was neither headquartered nor incorporated in the forum. 134 S. Ct. at 760. Motorola's argument that a bank such as SCB which did not raise a personal jurisdiction argument pre-Daimler has waived that argument is misplaced for the reasons stated by SCB, and, in any event, misses the point. Under Daimler, a restraint issued by a New York court cannot reach the non-New York branches of an international bank incorporated and headquartered outside New York simply on the basis of the presence of a branch in New York. This fundamentally alters the scope of Article 52 enforcement mechanisms as to international banks – a reality Motorola ignores.

To the extent that Motorola argues that New York's Banking Law subjects every foreign bank with a branch here to general personal jurisdiction, its position is equally misplaced. Section 200(3) of the Banking Law provides that by establishing a branch here, a bank agrees to designate the Superintendent as an agent for service of process "in any action or proceeding against it on a cause of action arising out of *a transaction with its New York agency or agencies or branch or branches*." N.Y. Banking Law § 200(3) (emphasis added). By its terms that section provides only a consent to service, not a consent to jurisdiction.[19] But even if it were not so limited by its plain terms, the provision would not assist Motorola, since the consent contained therein extends only to causes of action involving the conduct of the New York agency or branch, not foreign agencies or branches.[20]

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[19] Service on a corporation does not by itself establish jurisdiction; the corporation must also be subject to jurisdiction under relevant state statutory law and constitutional principles. See Daimler, 134 S. Ct. at 753 (citing Fed. Rule Civ. Proc. 4(k)(1)(A)) (noting that "service of process is effective to establish personal jurisdiction over a defendant '*who is subject to the jurisdiction of a court of general jurisdiction in the state where the district court is located*'"); Licci v. Lebanese Canadian Bank, SAL, 673 F.3d 50, 59 (2d Cir. 2012); Gager v. White, 53 N.Y.2d 475, 489 (1981) (noting distinction between "jurisdictional defense" and defense of "defective service"). Indeed, Daimler's holding would be meaningless if service on an office located within the forum created general jurisdiction, for in that case a corporation would always be subject to general jurisdiction in a forum where it had an office. Further, in each of the two cases addressing the doing business through an office basis for jurisdiction which the Court in Daimler found to be no longer entitled to precedential effect, service had been made on the local office. Barrow, 170 U.S. at 112; Tauza, 220 N.Y. at 269.

[20] Ins. Corp. of Ireland v. Compagnie des Bauxites de Guinee, 456 U.S. 694, 705 (1982) (Motorola Reply at 15), is irrelevant. Although it contains the commonplace proposition that a party may consent to personal jurisdiction, it did not address the New York Banking Law, or consider the effect of a statutorily mandated consent to service of process. Cases arising under the Business Corporation Law ("BCL") such as Doubet LLC v. Trustees of Columbia University in City of New York, 99 A.D.3d 433, 434-435 (1st Dep't 2012) (Motorola Reply at 15), are similarly inapposite. Among other things, the BCL designation of the Secretary of State as the

The restraint issued by Motorola has nothing to do with any action of SCB's New York branch.

Far from supporting the assertion of general jurisdiction over SCB (or other international banks with New York branches) the limited language of Section 200(3) reflects the Legislature's recognition that local branches of non-domestic banks are to be treated as distinct from the head office and other branches of such banks.[21] In contrast to the language of Section 200(3), which limits consent to service to matters relating to the New York agency or branch of a foreign bank, the designation of the Secretary of State as agent for service of process for general business corporations under Section 304 of the BCL (enacted in 1961) is unlimited in scope. The Legislature's decision to distinguish the scope of consent to service in the banking context from the business corporation setting is fundamentally at odds with Motorola's argument, discussed below, that the Legislature sub silentio overturned the separate entity rule by adopting Article 52 of the C.P.L.R. in 1962.

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agent for service of process is unlimited in scope, in contrast to the limited language of Section 200(3) of the Banking Law.

[21] The original version of Banking Law § 200(3) provided an unlimited consent for service of process in "any action or proceeding" brought by a resident of New York. See N.Y. Banking Law § 200(3) (1938). The scope of the consent to service was limited in 1951, when the Legislature amended that service of process provision to limit a bank's consent to service of process to "cause[s] of action arising out of a transaction with its New York agency or agencies." See N.Y. Banking Law § 200(3) (1951). Subsequently, in its 2006 amendment to the Banking Law, the Legislature clarified that this limitation operates to the foreign bank's New York "branch or branches" as well.

The other statute referenced by Motorola – N.Y. Banking Law § 200-b – is inapposite, as that section on its face deals with *subject matter* jurisdiction. Id. at 200-b(2) (listing types of actions that may be maintained against foreign banking corporations – not instances where a foreign banking corporation agrees to be subject to personal jurisdiction). Not surprisingly, the cases addressing Section 200-b describe it as dealing with subject matter jurisdiction. See, e.g., Indosuez Int'l Finance B.V. v. Nat'l Reserve Bank, 98 N.Y.2d 238, 248 (2002) (noting that Section 200-b "grants *subject matter jurisdiction* over claims by foreign parties" (emphasis added)). The cases cited by Motorola (Motorola Reply at 15, n.12) are to the same effect. In Byblos Bank Europe, S.A. v. Syrketi, 12 Misc. 3d 792, 793 (N.Y. Sup. Ct. 2006), the issue before the court was whether subject matter jurisdiction was present under Business Corporation Law § 1314 and Banking Law § 200-b, and the court so found because the subject matter of the litigation was situated in New York. The subject matter of the restraint issued against SCB is, of course, property located in the UAE. The court in Milan Indus. v. Wilson, 2011 N.Y. Misc. LEXIS 6842 (N.Y. Sup. Ct. June 1, 2011), also addressed subject matter jurisdiction rather than personal jurisdiction.[22]

[22] Indeed, in that case, the court found that it did not need a basis for personal jurisdiction over defendants for recognition and enforcement of a foreign judgment previously entered against defendants. Here of course, as Motorola concedes, personal jurisdiction is the "linchpin" of an enforcement proceeding against a non-party garnishee. Motorola Br. at 4, 16; Motorola Reply at 13. Motorola cites nothing that supports a conclusion that SCB has consented to all-purpose jurisdiction by New York courts.

Nor, of course, is there any basis to assert specific jurisdiction over a bank such as SCB in the circumstances here. Motorola Reply at 16.[23] Both as a constitutional matter, and under Section 302 of the C.P.L.R., specific jurisdiction is jurisdiction that exists over causes of action that "arise[] out of or relate[] to the defendant's [or in this case garnishee's] contacts with the forum." Daimler, 134 S. Ct. at 754; see also N.Y. C.P.L.R. § 302(a) ("As to a cause of action *arising from any of the acts enumerated in this section*, a court may exercise personal jurisdiction over any non-domiciliary, or his executor or administrator . . . ." (emphasis added)); Licci v. Lebanese Canadian Bank, SAL, 20 N.Y.3d 327, 340 (2012) (noting that "'arise-from' prong" of Section 302 "confer[s] jurisdiction only over those claims in some way arguably connected to the" contacts at issue).

As the Supreme Court emphasized in its recent Walden v. Fiore decision, for specific jurisdiction, the cause of action must arise out of the defendant's (in this case garnishee's) contacts with the forum, not from contacts with other parties. 134 S. Ct. 1115, 1123 (2014) ( "Due process requires that a defendant be haled into court in a forum State based on his own affiliation with the State, not based on the 'random, fortuitous, or attenuated' contacts he makes by interacting with other

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[23] Motorola cites no authority for the assertion of specific jurisdiction over SCB. Motorola Reply at 16. For the reasons noted above, there is no basis whatsoever for Motorola's suggestion that SCB could be subject to specific jurisdiction for purposes of this action, or that any other international bank in similar circumstances – where a plaintiff seeks to restrain assets located abroad merely by virtue of the presence of a New York branch – would be subject to specific personal jurisdiction as to such restraint.

persons affiliated with the State" (citation omitted)); see also Licci, 20 N.Y.3d at 340. Motorola's suggestion that, where, as here, a creditor seeks to restrain assets located at the non-U.S. branches of a bank simply due to the presence of a U.S. branch, a bank in SCB's position could be subject to specific jurisdiction (Motorola Reply at 16) is refuted by Walden. Here, the restraint does not arise from any contact between the bank or any of its branches and New York. To the contrary, the entire controversy between Motorola and SCB arises from the fact that an SCB branch in the UAE had a deposit relationship with a Jordanian bank that was identified as a proxy for the judgment debtors – i.e., SCB has accounts allegedly belonging to judgment debtors in the UAE. The relief that Motorola seeks – freezing accounts located outside of the U.S. – does not "arise from" any contact that the bank has with New York. Under Walden, this sort of fact pattern cannot support specific jurisdiction.

### C. The Separate Entity Rule Remains Important After Daimler To Provide A Level Playing Field For New York Banks

By circumscribing the exercise of personal jurisdiction necessary for the enforcement of Article 52 enforcement devices over banks incorporated and headquartered outside of New York, Daimler is entirely consistent with the separate entity rule as applied to such international banks. But Daimler does not directly impact the scope of Article 52 as to garnishee banks incorporated or headquartered in New York. Thus, a finding that the separate entity rule is no

longer viable could have the anomalous result of making domestic banks alone subject to worldwide restraint and turnover orders issued out of New York courts. If effect is given to Daimler's plain meaning, as it should be, then only those domestic banks would be regularly burdened with responding to such restraints and be placed in the difficult position of facing conflicting rules and orders with respect to accounts held abroad.

That result would be perverse – if the separate entity rule were abandoned, New York courts would be able to issue extraterritorial restraints *only* against bank entities that are incorporated or make their headquarters in New York. Ironically, the very concern expressed by Motorola in its brief – that "foreign banks [could be given] a competitive advantage over New York banks" (Motorola Reply at 47) – will occur not if the separate entity rule is upheld, as Motorola suggests, but if it is *disregarded*, as Motorola urges.

This reality poses a significant risk to New York's role as a leading money market center. If Motorola's position is adopted, U.S. domestic banks with international operations may choose not to incorporate or base their operations in New York. Although Motorola contends that there is "no meaningful risk" that this will be the case (id. at 45) Motorola cites nothing for this proposition. While New York has been "a leader in the banking industry" in the past (id. at 45), New York has also consistently applied the separate entity rule in the past, including,

specifically, to preserve New York's "preeminence in the international financial community." Bill Jacket, L. 1994, ch. 264, at 8 (SCB-ADD-124) (explaining reasoning behind bill "shield[ing] banks located in New York State from claims of depositors in their foreign branches"). To prevent the potential adverse impact on New York's status as a financial center, this Court should answer the certified question in the affirmative. See, e.g., Brian Rosner and Natalie A. Napierala, 'Daimler' Mostly Resolves New York's 'Separate Entity' Dispute, N.Y. Law Journal, March 18, 2014 ("Leveling the playing field between the New York 'at home' bank and its out-of-state competitors (domestic and foreign) is a policy reason for the New York Court of Appeals to reaffirm the separate entity rule by answering 'yes' to the Motorola certified question").

## III. MOTOROLA'S EFFORTS TO DIMINISH THE LONG-STANDING RECOGNITION OF THE SEPARATE ENTITY RULE ARE MISPLACED

The separate entity rule is a firmly entrenched rule of New York law, stretching back for decades and uniformly applied by New York courts (and recognized in New York statutory law). The rule was consistently applied by New York courts before the Koehler and Northern Mariana decisions, both in the pre- and post-judgment context, and continues to consistently be applied today.

### A. The Separate Entity Rule Has Been Historically Recognized In The Pre-Judgment And Post-Judgment Context, And The Legislature Did Not Override The Rule When It Enacted The C.P.L.R. In 1962

Motorola's attempt to avoid the separate entity rule by simply ignoring its existence fails. Motorola suggests that the separate entity rule never really "existe[d]" because the Legislature has not codified it or indicated any intent to treat banks differently than other garnishees and is at best a legal fiction adopted by only a few lower courts. Motorola Br. at 1. But, when the history of the rule in the courts and the C.P.L.R. is examined, it is clear that the separate entity rule is anything but illusory.

In fact, New York courts have consistently applied the separate entity rule in both the pre-judgment and post-judgment context since its inception, as have federal courts, including at the appellate level. See, e.g., Nat'l Union, 269 A.D. 2d at 101 (pre-judgment attachment); Therm-X-Chemical & Oil Corp. v. Extebank, 84 A.D.2d 787, 787 (2d Dep't 1981) (post-judgment restraint); Cronan, 100 N.Y.S.2d at 476, *aff'd*, 282 A.D. 940 (pre-judgment attachment); Intercont'l Credit Corp. v. Roth, 152 Misc. 2d 751, 752 (N.Y. Sup. Ct. 1990), *rev'd on other grounds*, 154 Misc. 2d 639 (N.Y. Sup. Ct. 1991) (post-judgment restraint); Walsh v. Bustos, 46 N.Y.S.2d 240 (N.Y. City Ct. 1943) (same); Clinton Trust, 172 Misc. at 150, *aff'd*, 258 A.D. 780 (pre-judgment attachment); Samsun, 2011 WL 1844061, at *5 and cases cited *infra* at p. 51-52 (post-judgment restraint and turnover); see also Det

Bergenske Dampskibsselskab v. Sabre Shipping Corp., 341 F.2d 50, 53 (2d Cir. 1965) ("A review of the New York cases indicates a consistent line of authority holding that accounts in a foreign branch bank are not subject to attachment *or execution* by the process of a New York court served in New York on a main office, branch, or agency of the bank" (emphasis added)); Shaheen, 2012 WL 919664, at *8 (post-judgment turnover order); Motorola Credit Corp. v. Uzan, 288 F. Supp. 2d 558, 560 (S.D.N.Y. 2003) (post-judgment restraint); Lok, 2002 WL 1585820, at *1 (post-judgment turnover order); Fid. Partners, Inc. v. Philippine Export & Foreign Loan Guarantee Corp., 921 F. Supp. 1113, 1119 (S.D.N.Y. 1996) (post-judgment attachment and execution).

Although this Court has never explicitly addressed the issue, a decision applying the separate entity rule to overturn an attachment did reach, and was affirmed by, this Court in McCloskey v. Chase Manhattan Bank, 11 N.Y.2d 936 (1962). The officially reported summary of that decision shows that the Court affirmed a decision holding that accounts at German bank branches were not subject to attachment. The New York appellate courts have treated McCloskey as confirming the separate entity rule. See Nat'l Union, 269 A.D.2d at 101 (citing McCloskey for the proposition that the separate entity rule is a "long-standing general rule in New York"); Therm-X, 84 A.D.2d at 787 (citing McCloskey for proposition that "[t]he general rule in New York is that in order to reach a

particular bank account the judgment creditor must serve the office of the bank where the account is maintained"). In National Union, the First Department went on to hold that the separate entity rule is so firmly embedded in New York law that the rule should not be altered absent an explicit "pronouncement from the Court of Appeals or an act of the Legislature." 269 A.D. 2d at 101. The Second Circuit has also cited McCloskey as support for its repeated recognition of the separate entity rule, both before and after Koehler, and as applying both in the pre-judgment and post-judgment contexts. See, e.g., Allied Mar., Inc. v. Descatrade SA, 620 F.3d 70, 74 (2d Cir. 2010) (citing McCloskey and other cases as support for application of separate entity rule); Det Bergenske, 341 F.2d at 53 (same).[24]

Throughout its history, the separate entity rule has been recognized as addressing the similar concerns raised in both the pre- and post-judgment context. That is reflected in cases decided both before and after the C.P.L.R. was adopted. For example, in Bluebird Undergarment Corp. v. Gomez, 139 Misc. 742, 743

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[24] The cases cited by Motorola which purport to "emphasize[] the critical distinction between prejudgment attachment and post-judgment enforcement proceedings" (Motorola Br. at 40) do nothing of the sort. Morgenthau v. Avian Res. Ltd., 49 A.D.3d 50 (1st Dep't 2007), involved an attachment in a criminal case issued initially upon an affirmation that the money to be forfeited was in New York County. The court ultimately *vacated* the attachment holding that the court "lacked jurisdiction to issue [it] because the funds were at that time deposited in a bank outside of New York," citing cases applying the separate entity rule. Id. at 54. The Appellate Division, in affirming the vacatur of the restraint, emphasized that "the property and garnishee in question were beyond the reach of the [] attachment order." Id. at 58. Gryphon Domestic VI, LLC v. APP Int'l Fin. Co., involved a restraining notice directed to a *debtor* and held that the "*defendant judgment debtors* could be ordered to turn over out-of-state assets to a New York sheriff." 41 A.D.3d 25, 37 (1st Dep't 2007) (emphasis added). The case did not involve a third-party garnishee of any kind, let alone a bank, and therefore did not in any way implicate the separate entity rule.

(N.Y. City Ct. 1931), in which the court considered whether service of a warrant of attachment on a bank in New York could reach "money on deposit in the bank's branch" in Puerto Rico, the court relied on an English case applying the separate entity rule in the post-judgment context (Richardson v. Richardson & The National Bank of India, Ltd., [1927] P. 228 (England) (SCB-ADD-011)), and recognized that the rule was, in general, "of far-reaching importance to the commercial and banking worlds." Bluebird, 139 Misc. at 743; see also Walsh, 46 N.Y.S.2d 240 (applying separate entity rule in post-judgment context). Cases subsequent to the adoption of the C.P.L.R. also recognize the rule as applying with equal force in both the pre- and post-judgment context. See, e.g., Det Bergenske, 341 F.2d at 53. The only limitation on the separate entity rule that has been recognized is that set forth in Digitrex, which, as noted above, applies *only* when the main office of the bank is served in New York, the bank branches are in the same jurisdiction (i.e., are in New York) and the branches are connected by high-speed computers. Nat'l Union, 269 A.D.2d at 101.

The separate entity rule has also been unanimously applied in the post-judgment context by the post-Koehler New York state court cases, which have *uniformly* found that the separate entity rule applies post-judgment and was not abrogated by Koehler. See Global Tech., 2012 WL 89823, at *13; Parbulk, 35 Misc. 3d at 238; Samsun, 2011 WL 1844061; see also SCB Br. at 61, n.31. The

majority of, and the more recent decisions from, the federal courts have also found that the separate entity rule continues to apply in the post-judgment context. See SCB Br. at 59, n.30 and 70, n.38.

Motorola's argument that the separate entity rule was "refute[d]" by the Legislature's adoption of the C.P.L.R. is equally misguided. Motorola Reply at 19. The C.P.L.R. was adopted in 1962, after the separate entity rule was firmly rooted in New York case law (see, e.g., Cronan, 100 N.Y.S.2d at 476, *aff'd,* 282 A.D. 940) and had been applied in both pre- and post-judgment cases. Moreover, in the "nine times since 1968" that C.P.L.R. § 5222 has been amended (Motorola Br. at 24; Motorola Reply at 29 n.25), the Legislature has failed to express any disagreement with the separate entity rule, despite its widespread and continued application (in both state and federal courts). Such amendments have occurred as recently as 2009 – well after the separate entity rule was applied in post-judgment proceedings, as even Motorola acknowledges. See Motorola Br. at 39, n.24.

Moreover, the same Legislature that enacted the C.P.L.R. in 1962 had codified the rule in the U.C.C. See N.Y. U.C.C. §§ 4-106 ("A branch or separate office of a bank is a separate bank for the purpose of computing the time within which . . . action may be taken or notices or orders shall be given under this Article and under Article 3. The receipt of any notice or order by or the knowledge of one branch or separate office of a bank is not actual or constructive notice to or

knowledge of any other branch or office of the same bank . . . .") and 4-102 ("The liability of a bank for action or non-action with respect to any item handled by it for purposes of presentment, payment or collection is governed by the law of the place where the bank is located. In the case of action or non-action by or at a branch or separate office of a bank, its liability is governed by the law of the place where the branch or separate office is located"). The rule remains prominent in the U.C.C. today. See id.; see also N.Y. U.C.C. §§ 4-A-105(1)(b) ("A branch or separate office of a bank is a separate bank for purposes of this article") and 4-A-502(d) ("[c]reditor process with respect to a payment by the originator to the beneficiary pursuant to a funds transfer may be served only on the beneficiary's bank with respect to the debt owed by that bank to the beneficiary. Any other bank served with the creditor process is not obligated to act with respect to the process"). Thus, under the U.C.C., creditor process is only effective if served on the branch of the beneficiary bank which ultimately received a transfer. See also Scanscot Shipping Services v. Metales Tracomex LTDA, 617 F.3d 679 (2d Cir. 2010); Allied Mar., 620 F.3d at 75.[25]

In arguing that in these circumstances the Legislature is deemed to have implicitly overridden an existing common law rule, Motorola turns the law on its

[25] As noted above (p. 42), the Legislature had recognized the important distinctions between the offices of foreign banks with a New York office in the Banking Law service provisions long before the enactment of the C.P.L.R.

head. Motorola cites nothing for its argument that the absence of any statutory language specifically espousing the separate entity rule should be "dispositive" of the certified question before the Court. Motorola Reply at 8. The applicable rule in these circumstances is whether the Legislature has included express language in its enactment that evinces an intent to disavow the rule. Arbegast v. Board of Educ. of S. New Berlin Cent. School, 65 N.Y.2d 161, 169 (1985) (the Legislature is "presumed to be aware of the decisional and statute law in existence at the time of an enactment, and to have abrogated the common law only to the extent that the clear import of the language used in the statute requires" (citation omitted)); Engle v. Talarico, 33 N.Y.2d 237, 242 (1973) ("Where the practical construction of a statute is well known, the Legislature is charged with knowledge and its failure to interfere indicates acquiescence"). That the Legislature in its amendments over the years made no change to Section 5222, the C.P.L.R.'s asset restraint provision (or Sections 5225, 5227, or 5232, which provide judgment creditors their ultimate remedy through turnover orders and levies), to repudiate the separate entity rule confirms its continued vitality. Motorola's repeated argument that the "plain language of Article 52 . . . refutes the existence of the separate entity rule'" (Motorola Reply at 17) ignores the fact that there is *nothing* in the "plain language" of that Article which repudiates, or even makes reference to, the rule, as Motorola

concedes. Id.[26]

Finally, Motorola's suggestion that the separate entity rule should be ignored because it would lead to an "anomalous" result, whereby New York state and federal courts would be able to order post-judgment discovery from third-party banks about assets located abroad but could not restrain or require turnover of such assets (Motorola Br. at 32-33) is misguided. While the application of the separate entity rule to post-judgment discovery is beyond the scope of the certified question in this case, Motorola's argument ignores the fact that, if a creditor did obtain information about assets located abroad but could not execute upon them in New York, it would still have an "effective remedy" (Motorola Br. at 33) in that it could go abroad to seek to execute on such assets.[27]

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[26] All of the cases cited by Motorola involve instances of courts interpreting unequivocal "language" and "words" in a statute; while here, of course, there is no language in C.P.L.R. 5222 referencing, let alone repudiating, the separate entity rule. See Motorola Br. at 26-27 and Motorola Reply at 17 (citing In re Amorosi, 9 N.Y.3d 367, 372 (2007); Pultz v. Economakis, 10 N.Y.3d 542, 548 (2008); People v. Finnegan, 85 N.Y.2d 53, 58 (1995); Doctors Council v. New York City Emps.' Ret. Sys., 71 N.Y.2d 669, 674-675 (1988)).

Motorola's argument that the separate entity rule is a "legal fiction" because it is based on "policy choices" lacking a statutory basis apparently rests on the unwarranted premise that a common law rule that has been repeatedly and consistently applied by New York courts is not a real rule if it does not have a statutory basis. Motorola Reply at 20. New York courts are of course capable of creating common law rules and doctrines that apply as the law of New York. N.Y. CONST. art. I, § 14 (stating that the "common law" and "acts of the legislature" in force "shall be and continue the law of this state"); People v. Peque, 22 N.Y.3d 168, 194 (2013).

[27] Motorola's argument also ignores the fact that, in the context of international banks not headquartered or incorporated in New York, Daimler would seem to preclude the issuance of post-judgment extraterritorial discovery orders based on general jurisdiction precepts. See *supra* at pp. 36-40.

### B. The Cases Motorola Cites Did Not Abrogate The Separate Entity Rule

Although Motorola concedes that this Court "never mentioned" the separate entity rule in its 2009 decision in Koehler, 12 N.Y.3d 553, or its 2013 decision in Northern Mariana, 21 N.Y.3d 55 (Motorola Br. at 17-18, 27-33; Motorola Reply 8-14), Motorola nonetheless argues that these cases implicitly abrogated the separate entity rule. That is not the case.

Koehler did not involve the separate entity rule, let alone alter that rule. The bank in that case, Bank of Bermuda, had a New York subsidiary (not a branch). Although the bank had initially raised a personal jurisdiction objection, it ultimately stipulated that the bank itself (the head office that held the property at issue, not just the subsidiary) was subject to personal jurisdiction in New York. Koehler, 12 N.Y.3d at 533. Because Bank of Bermuda's head office, which was holding the property at issue, was thereby actually present in New York, the case did not implicate the separate entity rule.[28] Neither party – the judgment creditor, Koehler, nor the respondent, Bank of Bermuda, mentioned the separate entity rule

[28] The district court decision in the federal action expressly concluded that "the separate entity rule has no role to play in this case, since the rule involves circumstances where a party attempts to obtain the assets of an entity's foreign or auxiliary branch through service of its main branch. Here, the foreign branch itself was properly served." Koehler v. Bank of Bermuda Ltd., No. M18-302, 2005 WL 551115, at *12 (S.D.N.Y. March 9, 2005). Giving effect to this Court's opinion, the Second Circuit did not mention the separate entity rule, and emphasized that since Bank of Bermuda had consented to "personal jurisdiction" as of the commencement of the proceeding in 1993, the district court had authority to issue a turnover order as of that date. See Koehler v. Bank of Bermuda Ltd., 577 F.3d 497 (2d Cir. 2009).

in its initial brief to this Court. See Koehler v. Bank of Bermuda Ltd., Brief for Petitioner-Appellant Lee N. Koehler, No. 2009-0082, 2008 WL 6191439 (N.Y. Dec. 12, 2008); Koehler v. Bank of Bermuda Ltd., Brief for Respondent the Bank of Bermuda Limited, No. 2009-0082, 2009 WL 1615260 (N.Y. Feb. 4, 2009). Koehler referred to the rule only in his reply to an amicus brief, and then stated that the rule is "inapplicable where, as here, the judgment creditor seeks to obtain funds of the debtor *held by the branch of the bank upon which service has been made*." Koehler v. Bank of Bermuda Ltd., Appellant's Reply to Amicus Curiae Brief of The Clearing House Association L.L.C., No. 2009-0082, 2009 WL 1615263, at *29-30 (N.Y. Apr. 16, 2009) (emphasis added).[29]

Thus, this Court did not need to, and did not, address the separate entity rule, and no cases relating to the rule were cited or discussed by the Court. Under this Court's case law, in these circumstances the Koehler decision should not be deemed to implicitly overrule the long-standing separate entity rule. See K2 Inv. Grp. v. Am. Guar. & Liab. Ins. Co., 22 N.Y.3d 578, 584, 586 (2014) (decisions which do not address a settled rule of law "should not be read as silently overruling" such rule); see also Tire Eng'g, 740 F.3d at 115 ("in light of the

[29] The Clearing House in its amicus brief was simply expressing the legitimate concern that the Court not answer the certified question in Koehler in a way that altered the separate entity rule. In response, the parties argued to the Court that the rule was not at issue (as the district court had concluded), and in addressing the certified question, this Court did not reference or address the separate entity rule.

longstanding application of the separate entity rule in New York, . . . we doubt that the Court of Appeals intended to silently overrule the doctrine [in Koehler]").[30]

As discussed above, the Court's emphasis in Koehler on the *in personam* nature of judgment enforcement devices does not militate in favor of overruling the separate entity rule. Given the circumscribed scope of general jurisdiction under Daimler, there is no jurisdictional predicate for extending a restraint to foreign branches of an international bank based merely on the presence of a branch here.

Northern Mariana also does not address the separate entity rule, does not address post-judgment restraints directed to non-party foreign bank branches, and does not support a conclusion that such restraints are appropriate. Thus, the Court's conclusion that the use of the word "control" in Section 5224 (addressing post-judgment discovery) rendered that provision broader than Section 5225's turnover provisions does not assist Motorola.

If anything, Northern Mariana undermines Motorola's position because the Court unanimously rejected an "attempt to broadly construe *Koehler*," and held that under New York law a garnishee could not "be compelled to direct another entity, which is not subject to this state's personal jurisdiction, to deliver assets

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[30] In light of the considerable uncertainty immediately following Koehler about how courts would treat the separate entity rule, it should be of no surprise that efforts were made to have the Legislature amend the C.P.L.R. to clarify the continuing viability of the separate entity rule. Motorola Br. at 24; Motorola Reply at 27-28. Such efforts are hardly an acknowledgement that the separate entity rule was modified by Koehler, or that the Legislature had not confirmed that rule through its silence.

held in a foreign jurisdiction" to satisfy a judgment. 21 N.Y.3d at 64. As discussed above, under Daimler, international banks operating in New York through branches, which are not headquartered or incorporated in New York, are not subject to the personal jurisdiction of New York courts, and thus cannot be compelled to take action with respect to assets located outside of the jurisdiction.

## CONCLUSION

For the foregoing reasons, the Institute of International Bankers, The Clearing House Association L.L.C., the European Banking Federation, and the New York Bankers Association respectfully urge the Court to answer the question certified by the Second Circuit in the affirmative.

Dated: July 21, 2014

WHITE & CASE LLP

By:

Dwight A. Healy
Ernest T. Patrikis
Owen C. Pell
Marika M. Lyons
1155 Avenue of the Americas
New York, New York 10036
Telephone: (212) 819-8200
Facsimile: (212) 354-8113

*Counsel for Institute of International Bankers, The Clearing House Association L.L.C., European Banking Federation* and *New York Bankers Association*

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# SUBSIDIARY REQUIREMENT

# STUDY

**DEPARTMENT
OF THE
TREASURY**

**BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM**

SECTION 215 SUBSIDIARY REQUIREMENT STUDY

## EXECUTIVE SUMMARY

Pursuant to section 215 of the Foreign Bank Supervision Enhancement Act ("FBSEA"), the Secretary of the Treasury and the Board of Governors of the Federal Reserve System, in consultation with the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Attorney General, have conducted a study of "whether foreign banks should be required to conduct banking operations in the United States through subsidiaries rather than branches," taking into account a number of factors specified by the legislation. The conclusions of the study are summarized briefly below.

A subsidiary requirement applied to all foreign banking operations either across-the-board or for purposes of expanded powers would impose substantial economic and financial costs on the U.S. operations of foreign banks. In fact, a branch of a foreign bank is able to operate more efficiently than a separate subsidiary of a foreign bank, due to a number of factors: (1) the ability to deploy capital flexibly; (2) a lower cost of funding; (3) the ability to compete based on access to the worldwide capital base of its parent; (4) ability to engage in transactions with the home office without significant operational restrictions; and (5) lower transactions costs.

As of June 1992, 82 percent of all U.S. assets held by foreign banks are maintained in branches and agencies.[1] If the United States were to require that foreign banks conduct their U.S. operations in subsidiaries, the availability of credit in the United States market could be reduced, perhaps substantially. For example, the participation of foreign banks in lending syndicates, trade finance, and transactions in foreign exchange, swaps and other products would be restricted by the increase in costs and by their inability to access their worldwide capital base. Foreign countries might also retaliate against U.S. bank branches, perhaps by requiring that they establish a subsidiary or by otherwise restricting their activities.

One possible justification for an across-the-board subsidiary requirement is the belief that it safeguards financial stability. However, more appropriate and effective measures are available for purposes of protecting safety and soundness. These include the promotion of adequate supervisory standards worldwide and the right to prohibit access to the U.S. market by banks that are not adequately supervised. The FBSEA, as well as the minimum standards for consolidated supervision established by the Basle Committee on Banking Supervision, represent important steps in this direction. Importantly, both measures implicitly endorse foreign bank branches.

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[1] Foreign branches of U.S. banks also hold a majority (64 percent) of all foreign assets held by U.S. banks abroad.

For purposes of protecting safety and soundness, measures other than a subsidiary requirement also may be applied to branches of foreign banks experiencing financial difficulties. These include asset maintenance requirements and restrictions on transactions between a branch and the foreign bank's other offices that "wall-off" or "ring-fence" the activities of the branch from those of the troubled foreign bank without imposing the unnecessary costs and inefficiencies associated with a broader subsidiary requirement. In the past, these measures have successfully addressed problems arising in relation to branches of foreign banks experiencing financial difficulty without penalizing the activities of branches of healthy foreign banks.

Another possible justification for a subsidiary requirement was the belief that differences in capital and regulatory standards might place U.S. banks at a competitive disadvantage in their own market. In this regard, the guidelines established pursuant to section 214(b) of the FBSEA in the Report on Capital Equivalency provide assurances that foreign banks operating in the United States are subject to capital requirements equivalent to those imposed upon U.S. banking organizations such that U.S. banks are not placed at a competitive disadvantage in their own market with regard to capital standards. The joint annual updates on capital equivalency also provide the Federal Reserve Board and Treasury opportunity to ascertain that foreign banks are meeting capital and accounting standards equivalent to those required of U.S. banking organizations.

With regard to the other factors specified in section 215 of the FBSEA, which include considerations relating to deposit insurance, money laundering, tax, bankruptcy, and international trade, the agencies agree that none of these factors provides support for a subsidiary requirement.

After carefully examining all of the factors contained in the legislation, the Treasury and the Board would oppose a subsidiary requirement that would be applied to all foreign bank operations either across-the-board or for purposes of expanded powers. The Treasury and the Federal Reserve Board consistently have opposed a subsidiary requirement that would be applied to all foreign banking operations in the United States. The inter-agency review of regulatory developments reveals several significant changes since the introduction of the 1991 Administration proposal. The agencies, therefore, agree that the various factors to be considered do not justify a "roll-up" of foreign bank branches should expanded powers be permitted to U.S. banks.

Instead, subject to prudential considerations, the guiding policy for foreign bank operations should be the principle of investor choice. The right of a foreign bank to determine whether to establish a branch or a subsidiary is consistent with competitive equity, national treatment and equality of competitive opportunity. Foreign countries with banks that are provided national treatment and equality of competitive opportunity in the U.S. market should offer U.S. banks national treatment and competitive equity in their markets.

In the Uruguay Round negotiations, NAFTA discussions, and bilateral negotiations, U.S. officials have impressed upon other countries the importance of providing equality of competitive opportunity to U.S. banks and they will continue to do so. The Treasury and the Board recognize that it is important to assure that U.S. negotiators have the necessary tools to advance U.S. interests abroad. However, the agencies agree that a subsidiary requirement applied to all foreign banking operations either across-the-board or for purposes of expanded powers is not desirable even in this context.

I. INTRODUCTION

Operations of foreign banks have expanded in the U.S. market in recent years. Their share of U.S. banking assets has nearly doubled from 12 percent in December 1980 to 23 percent in June 1992.[2] The growth in foreign bank activities in the United States has added to the liquidity of the U.S. market while deepening the availability of credit to borrowers. For example, foreign bank operations have grown partially in response to the growth in foreign investment in and trade with the United States. Foreign banks have been especially active in wholesale activities, which include trade finance, commercial loan syndications, swaps and foreign exchange activities.

In the light of the expanding operations of foreign banks in the United States and the difficulties experienced with criminal activity and unsound practices at a small number of foreign banks over the past several years, a need was identified for legislation that would fill gaps in the supervisory and regulatory framework governing foreign bank operations in this country. To this end, the Foreign Bank Supervision Enhancement Act (FBSEA) was passed by Congress and signed into law by the President, as Title II of the Federal Deposit Insurance Corporation Improvement Act of 1991. The FBSEA established uniform federal standards for entry and expansion of foreign banks

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[2] Appendix A contains tables and charts, as well as a brief narrative, describing the growth in foreign bank operations in the United States.

in the United States, which broadly parallel the regulatory regime and standards applicable to U.S. banks.

In light of the growth in U.S. operations of foreign banks and in order to assure that U.S. and foreign banks are treated on an equivalent basis in the U.S. market, the FBSEA also mandated that the Department of the Treasury (Treasury) and the Board of Governors of the Federal Reserve System (Board) should conduct two studies. The first of these studies, the Report on Capital Equivalency, which was required by section 214(b) of the FBSEA, was submitted to Congress by the Treasury and the Board in June 1992.

This study, the Subsidiary Requirement Study, is required by section 215 of the FBSEA. Section 215 requires that the Secretary of the Treasury, jointly with the Board (hereafter collectively referred to as "the agencies") and in consultation with the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Attorney General conduct a study of "whether foreign banks should be required to conduct banking operations in the United States through subsidiaries rather than branches." In conducting the study, the legislation requires that the Secretary take into account the following factors:

(1) differences in accounting and regulatory practices abroad and the difficulty of assuring that the foreign bank meets United States capital and management standards and is adequately supervised;

(2) implications for the deposit insurance system;

(3) competitive equity considerations;

(4) national treatment of foreign financial institutions;

(5) the need to prohibit money laundering and illegal payments;

(6) safety and soundness considerations;

(7) implications for international negotiations for liberalized trade in financial services;

(8) the tax liability of foreign banks;

(9) whether the establishment of subsidiaries by foreign banks to operate in the United States should be required only if United States banks are authorized to engage in securities activities and interstate banking and branching; and

(10) differences in treatment of United States creditors under the bankruptcy and receivership laws.

The legislation also requires that by December 19, 1992, the Secretary transmit to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives a report on the results of the study. Any additional or dissenting views of participating agencies shall be included in the report.

The full text of section 215 of the FBSEA is attached as Appendix B.

## II. ASSESSMENT OF THE FACTORS TO BE CONSIDERED

Working groups comprised of staff from the agencies were formed to consider the factors identified in section 215 of the FBSEA and papers addressing these factors were drafted.[3] The

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[3] The factors relating to competitive equity, national treatment and new powers are addressed in one paper, as are the factors regarding accounting, regulatory and management practices and safety and soundness considerations.

factor papers, which address the following subjects, are attached as Appendices C, D and E.

| | | |
|---|---|---|
| *APPENDIX C* | *REGULATORY IMPLICATIONS* | *ACCOUNTING, REGULATORY AND MANAGEMENT PRACTICES*<br><br>*SAFETY AND SOUNDNESS*<br><br>*DEPOSIT INSURANCE SYSTEM* |
| *APPENDIX D* | *NATIONAL TREATMENT/*<br><br>*FINANCIAL SERVICES IMPLICATIONS* | *COMPETITIVE EQUITY*<br><br>*NATIONAL TREATMENT*<br><br>*NEW POWERS*<br><br>*INTERNATIONAL NEGOTIATIONS* |
| *APPENDIX E* | *OTHER IMPORTANT IMPLICATIONS* | *MONEY LAUNDERING AND ILLEGAL PAYMENTS*<br><br>*TAX IMPLICATIONS*<br><br>*BANKRUPTCY AND RECEIVERSHIP* |

The findings and conclusions of the papers prepared by the inter-agency working groups are summarized below.

A. Regulatory Implications

This section summarizes the conclusions reached in the factor papers regarding the advantages and disadvantages of a subsidiary requirement when considered in the light of regulatory practices, safety and soundness considerations and implications regarding the deposit insurance fund. See Appendix C for the full text of the relevant factor papers.

1. Regulatory Practices and Safety and Soundness Considerations

a. Regulatory Practices

Regulatory practices in this context were considered to encompass considerations such as differences in accounting and regulatory practices abroad as well as assuring that the foreign bank meets United States capital and management standards and is adequately supervised. Regardless of whether an application has been filed for the establishment of a branch, agency or subsidiary, in evaluating applications, regulators consider, among other factors, capital, profitability, concentration of risk, liquidity and asset quality. Differing regulatory and accounting practices also are taken into account by federal banking supervisors and must be explained by the applicant. In this regard, all U.S. operations of foreign banks must maintain records and conduct operations in accordance with U.S. practices. Home country authorities are contacted routinely to obtain information that bears on the management, reputation and standing of a foreign bank filing an application to open a branch, agency or subsidiary. Although differences remain among supervisory practices, efforts to harmonize regulatory practices continue.

The agencies do not believe differences in regulatory practices warrant a subsidiary requirement, especially given significant regulatory developments in the United States and abroad. The FBSEA requires that foreign banks be subject to comprehensive supervision on a consolidated basis to be permitted entry into the U.S. market through a branch, agency or subsidiary

bank. The statute and the implementing regulations adopted by the Board should provide ample supervisory authority with respect to direct U.S. offices of foreign banks. In addition, under section 214(b) of the FBSEA, foreign banks with U.S. branches are expected to meet capital standards "equivalent" to those required of U.S. banks. The establishment of minimum standards for consolidated supervision of international banking groups and their cross-border establishments by the Basle Committee on Banking Supervision ("Basle Committee") also represents an important step towards harmonization of regulatory standards.

b. Safety and Soundness Considerations

A subsidiary requirement for all foreign bank operations would require that the foreign bank conduct its U.S. operations in a separate legal entity. The actions of the subsidiary bank would not be attributed to the parent, which would be required neither to support the operations nor to meet the obligations of its subsidiary. The subsidiary's capital base would be segregated from that of its parent, and the ability of the subsidiary to transact business with its parent would be closely controlled. The subsidiary bank also would be subject to assessments for the deposit insurance fund. Finally, a subsidiary would be denied the benefits of being an integral part of a larger more diversified organization.

A parent could choose (in extremis) to allow its subsidiary to fail, although this could affect adversely the parent bank's reputation and its ability to obtain funding.

Conversely, a failure of the parent bank could cause difficulties for a subsidiary, including liquidity problems, to the extent that there is a market identification of the subsidiary with the parent bank. The strength of the parent, therefore, is a highly relevant consideration for supervisors in assessing the safety and soundness of a separately capitalized subsidiary.

The safety and soundness of a branch of a foreign bank is closely linked with that of its parent. However, bank supervisory authorities in some countries have taken steps to make foreign bank branches behave more like subsidiaries. These restrictions can have the effect of insulating the financial condition of the branch or agency from that of the rest of the organization in much the same manner as the incorporation of a separate subsidiary. Such restrictions have been applied by U.S. supervisors to address particular prudential concerns in problem cases. However, general application of such restrictions would have the effect of denying the foreign bank the economic benefits that accrue to the branch form of operation.

We do not believe that a subsidiary requirement is necessary to assure that foreign banks' direct banking operations in the United States are conducted in a safe and sound manner. Experience to date demonstrates that the U.S. banking operations of a foreign bank can function safely under either the branch or the subsidiary form of organization. The advantages or disadvantages of a branch or subsidiary primarily relate to operational differences and do not support a conclusion that one

form is inherently more safe and sound than the other. Continuing convergence of supervisory standards, including the comprehensive supervision of banking organizations operating internationally, should enhance the ability of supervisors to monitor and enforce safety and soundness.

2. Deposit Insurance Considerations

U.S. bank subsidiaries of foreign banks must obtain FDIC insurance on the same basis as other U.S. banks. Section 214(a) of the FBSEA (as amended) prohibits foreign banks from establishing new insured ("retail deposit-taking") branches in the United States.[4] If foreign banks wish to engage in retail deposit-taking activities, they must establish a subsidiary and obtain FDIC insurance.

With the exception of a limited number of grandfathered branches, foreign bank branches and agencies do not accept insured deposits and, therefore, neither contribute to nor draw from the deposit insurance fund. Accordingly, the imposition of a subsidiary requirement would increase the assessment base, the contingent liabilities, and the potential exposure of the FDIC. The increased risk exposure of the FDIC could be heightened as a result of the enhanced ability of a foreign bank parent to withhold support from a separately incorporated subsidiary.

A subsidiary requirement would prompt many foreign banks to undertake actions that would permit them to avoid paying

[4] A total of 52 branches of "insured" foreign banks with $4.7 billion in non-IBF deposits were grandfathered from this provision.

deposit insurance assessments. For example, these actions might include moving U.S. business offshore, booking deposits in an International Banking Facility (IBF), or converting deposits into other instruments that would not be subject to deposit insurance. These actions could temper the size of the increase in the assessment base.

B. National Treatment/Financial Services Implication

This section summarizes the national treatment and competitive equity implications of a subsidiary requirement, applied either across-the-board or in connection with the liberalization of banking powers. This section also examines the impact of a subsidiary requirement on international negotiations for liberalized trade in financial services. See Appendix D for the full text of the working group papers addressing these issues.

1. Competitive Equity and National Treatment Considerations

Bank branches enjoy certain economic and financial benefits that are not available to subsidiaries, which include: (1) the ability to deploy capital flexibly; (2) a lower cost of funding; (3) the ability to compete based on access to the worldwide capital base of its parent; (4) freedom to engage in transactions with the parent without significant restriction; and (5) lower transactions costs. As of June 1992, branches and agencies of foreign banks together held slightly more than four-fifths (82 percent) of all assets held by foreign banks in the United States, while foreign branches of U.S. banks held 64 percent of all assets held abroad by U.S. banks. These figures

demonstrate a general preference for the use of branches in comparison with subsidiaries.[5] In short, branch operations of foreign banks provide numerous economic and financial advantages to consumers and financial institutions in the United States and abroad.

Imposition of an "across-the-board" (unqualified) subsidiary requirement would necessitate a major restructuring of foreign banks' operations in the United States, which would reduce the depth, efficiency and competitiveness of the U.S. banking market. It could prompt foreign countries to retaliate, making it more difficult for U.S. banks to branch abroad. These countries might introduce a subsidiary requirement or review whether to permit U.S. banks to engage in activities that are prohibited in the U.S. market. Finally, countries that might otherwise consider dropping their own subsidiary requirement (e.g., Canada or Mexico) might reconsider if the United States were to adopt such a requirement.

An across-the-board subsidiary requirement would also be unnecessary under the minimum standards for consolidated supervision adopted by the Basle Committee, which has sought to strengthen supervision by stressing the primary responsibilities of the home country with respect to its foreign bank branches. Neither the Treasury nor the Board believes that such an unqualified subsidiary requirement is warranted.

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[5] See Appendix A for further detail regarding the extent and form of foreign banks' operations in the United States and of U.S. banks' operations abroad.

The agencies also examined whether a subsidiary requirement should be imposed for banking operations of foreign banks in the United States if U.S. banking organizations are permitted to engage through separately incorporated subsidiaries in securities activities or interstate banking and branching. Under this type of approach, only those foreign banks that wished to avail themselves of the expanded powers would be required to restructure their branch operations into subsidiary form.

The Administration's 1991 financial modernization proposal, which ultimately was not adopted, was broadly along these lines.[6] Under this proposal, new powers would have been authorized to those U.S. financial services holding companies with "well-capitalized" banks. Foreign banks that wished to obtain expanded powers (which under the proposal included securities and insurance activities) would have been required to "roll-up" all existing branch and agency operations into one or more well-capitalized U.S. bank subsidiaries of a financial services holding company.

Significant banking developments have transpired since the Administration introduced its 1991 proposal. Several developments have strengthened the ability of regulators to supervise the direct offices of foreign banks in the United States. The adoption of the FBSEA has strengthened the regulators' authority to assure that untoward actions do not

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[6] The Financial Institutions Safety and Consumers Act of 1991 (FISCCA).

jeopardize the safety and soundness of the financial system.[7] The establishment of the minimum standards for consolidated supervision by the Basle Committee on Banking Supervision also represents an important step towards harmonization of supervisory efforts with regard to foreign bank branches.

In addition, the Report on Capital Equivalency, mandated by Congress in section 214(b) of the FBSEA, establishes guidelines that help assure that U.S. banks will not be placed at a competitive disadvantage in their own market. As a result, "roll-up" is no longer necessary on competitive equity grounds. The joint annual updates on capital equivalency also provide the Board and the Treasury opportunity to ascertain that foreign banks are meeting capital and accounting standards equivalent to those required of U.S. banks.

The United States has generally followed the principle of national treatment with respect to financial services. National treatment is based on the principle of nondiscrimination between domestic and foreign firms, or treatment that is "no less favorable than that accorded in like circumstances to domestic enterprises." The United States endorsed a _de facto_ national treatment standard and "equality of competitive opportunity" in

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[7] FBSEA requires that the Board in consultation with Treasury, establish criteria for banks from countries that do not provide comprehensive supervision on a consolidated basis.

the International Banking Act of 1978.[8] This principle is embodied in the OECD Codes of Liberalization, the North American Free Trade Agreement (NAFTA), and current policies adopted in connection with the Uruguay Round of the GATT negotiations.

Consistent with this principle, the United States believes that, subject to any relevant prudential considerations, the guiding policy for foreign bank operations should be the principle of investor choice. The right of a foreign bank to determine whether to establish a branch or a subsidiary is consistent with competitive equity, national treatment and equality of competitive opportunity. The U.S. Government has pursued this policy in a wide range of fora, including the Uruguay Round, NAFTA, and bilateral negotiations. Nevertheless, some countries have continued to restrict the right of U.S. banks to branch in their markets.

Some have suggested that, following the adoption of reciprocal national treatment authority by many major U.S. trading partners, the U.S. Government also should be granted authority to apply a reciprocal national treatment standard.[9] With regard to

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[8] For a discussion of equality of competitive opportunity and the distinctions between de facto and de jure national treatment, see the 1979 Report to Congress on Foreign Government Treatment of U.S. Commercial Banking Organizations, pages 1-3 and 15-18.

[9] A country that provides reciprocal national treatment grants national treatment to banks from another country contingent upon that country providing national treatment to its banks. By January, 1993, when the EC Second Banking Directive is due to be implemented by member states, at least 18 of the 24 OECD countries (including the 12 EC member states) will possess some type of reciprocity powers.

establishment, this could mean that a subsidiary requirement could be imposed upon banks from countries that do not permit: (1) U.S. banks to branch; (2) U.S. bank branches the full benefits granted their own bank branches; and/or (3) national treatment and equality of competitive opportunity to U.S. banks and bank holding companies. This action could cause the affected country to provide national treatment and equality of competitive opportunity; alternatively, it could cause the country to retaliate and restrict further access by U.S. banks.

2. Financial Services Negotiations

A subsidiary requirement for all foreign banking operations in the United States could raise questions of interpretation with regard to Friendship, Commerce and Navigation (FCNS) Treaties and Bilateral Investment Treaties (BITs), the OECD Codes, and the U.S.-Canada Free Trade Agreement. However, under the NAFTA, a subsidiary requirement that applied to all other countries, while permissible, could impair the prospect for U.S. banks to achieve branching rights into Mexico and Canada at a future date. This could occur despite the arrangement for additional liberalization agreed in the NAFTA with respect to foreign bank branching.

Under a proposed Uruguay Round Services Agreement, a subsidiary requirement under U.S. law could require reservations to market access commitments of the United States and would be inconsistent with U.S. objectives in the Round. It also would be likely to affect adversely on-going negotiations with developed

countries to lock-in existing branching rights of U.S. banks abroad. With respect to markets that do not permit branching, a targeted subsidiary requirement could tend to discourage further efforts to liberalize in these markets. It is also possible that the threat of a subsidiary requirement might serve as leverage for further liberalization.

C. Other Important Implications

This section addresses the implications of a subsidiary requirement when considered in the light of the need to prevent money laundering and illegal payments and considerations relating to tax and bankruptcy. See Appendix E for the full text of the papers addressing these issues.

1. Money Laundering Considerations

All foreign banks doing business in the United States, regardless of whether they are operating a branch or a subsidiary, are subject to the Bank Secrecy Act (BSA). The BSA sets forth the currency reporting and recordkeeping requirements for banks and other financial institutions. It has evolved into the major anti-money laundering legislation aimed at the activities of banks. The ability of regulatory and law enforcement officials to assess and ensure compliance with the BSA and to detect and prosecute money laundering is not affected materially by whether a foreign bank chooses to conduct business as a branch or a subsidiary in the United States.

2. Tax Considerations

The effect of a subsidiary requirement on the tax

liability of a foreign bank would vary for banks from different countries, due to: (1) differences in home country tax laws; (2) the existence of U.S. income tax treaties with some, but not all, home countries; and (3) differences between the provisions of existing U.S. income tax treaties with different countries. Some preliminary conclusions can be drawn, however, as to whether particular tax-related consequences of a subsidiary requirement would tend to have a neutral or non-neutral effect on a foreign bank's tax liability and whether this effect would depend upon tax treaties or home country law.

The conversion of a branch into a subsidiary would generally be a tax-free transaction for purposes of U.S. taxation, but the home country tax consequences of the conversion would vary. However, the subsidiary would not be permitted to carry over (following conversion) any net operating losses that had been accumulated by the former U.S. branch. With that one important exception, the tax treatment of a subsidiary is generally equivalent to that of a branch. However, differences between the taxation of a branch and a subsidiary may be affected significantly by U.S. income tax treaties.

It is conceivable that a subsidiary requirement could induce a foreign bank to shift U.S. loans to foreign offices, as a result of limits that would apply to the subsidiary regarding amounts that may be lent to single borrowers. Interest paid by U.S. borrowers to foreign banking offices would be subject to gross basis U.S. withholding tax. Although a number of U.S.

income tax treaties would eliminate this withholding tax, there are countries for which either no U.S. income tax treaty exists or the applicable treaty retains a positive withholding rate for interest. In these cases, the U.S. withholding tax on interest could eliminate a foreign bank's net profit on a U.S. loan made from the home office. This could result in a reduction in lending in the U.S. market by the affected foreign banks.

3. Bankruptcy Considerations

Under U.S. law, a creditor of an insolvent U.S. branch of a foreign bank would be treated in much the same manner as a creditor of an insolvent domestic bank subsidiary of a foreign bank parent. Each would have access to assets of the branch or subsidiary under the jurisdiction of the U.S. liquidator.

Potentially, a creditor of a branch would have access to the worldwide assets of the foreign bank. A creditor of a subsidiary would not have any legal claim to the assets of the parent bank, assuming that no legal or factual basis exists for piercing the corporate veil. A subsidiary requirement, therefore, would potentially limit the assets available to creditors in the event of liquidation.

III. CONCLUSIONS

A subsidiary requirement applied either across-the-board or for purposes of expanded powers ("roll-up") would impose substantial economic and financial costs on the U.S. operations of foreign banks. By not permitting foreign banks the option of conducting U.S. operations in branches, the availability of credit

in the U.S. market could be reduced, perhaps substantially. For example, the participation of foreign banks in lending syndicates, trade finance, and swaps and other products would be greatly restricted by the increase in costs and their inability to access their worldwide capital base. Imposition of such a subsidiary requirement would likely prompt foreign countries to retaliate against U.S. bank branches, perhaps by requiring that they establish a subsidiary or by restricting their activities.

Although some might argue that an unqualified subsidiary requirement would safeguard financial stability, more appropriate and effective measures are available for purposes of protecting safety and soundness. These include the promotion of adequate supervisory standards worldwide and the right to prohibit access to the U.S. market by banks that are not adequately supervised. The FBSEA, as well as the minimum standards for consolidated supervision established by the Basle Committee, represent important steps in this direction. Significantly, both measures implicitly endorse foreign bank branches.

In addition, U.S. bank regulators may impose specific measures upon troubled banks, including asset maintenance requirements and restrictions on transactions between a branch and its parent, that "wall-off" or "ring-fence" the activities of a branch from those of its troubled parent without the unnecessary costs and inefficiencies associated with a subsidiary requirement. In the past, these measures have successfully addressed problems

arising at branches of troubled foreign banks without penalizing the activities of branches of healthy foreign banks.

The earlier case for roll-up was based upon the belief that differences in capital and regulatory standards might place U.S. banks at a competitive disadvantage in their own market. In this regard, the guidelines established in the Report on Capital Equivalency provide assurance that U.S. banks will not be placed at a competitive disadvantage in their own market. The joint annual updates on capital equivalency also provide the Board and the Treasury opportunity to ascertain that foreign banks are meeting capital and accounting standards equivalent to those required of U.S. banks.

Based upon an examination of all ten factors included in the legislation, the agencies oppose a subsidiary requirement that would be applied either across-the-board or for purposes of expanded powers ("roll-up"). The Treasury and the Board consistently have opposed a subsidiary requirement that would be applied to all foreign banking operations in the United States. The interagency review of regulatory developments reveals several significant changes since the introduction of the 1991 Administration proposal. The agencies, therefore, agree that neither competitive equity nor prudential considerations justify a "roll-up" of foreign bank branches should expanded powers be permitted to U.S. banks.

The United States believes that the guiding policy for foreign bank operations should be the principle of investor choice. The right of a foreign bank to determine whether to establish a

branch or a subsidiary is consistent with competitive equity, national treatment and equality of competitive opportunity. Foreign countries with banks that are provided national treatment and equality of competitive opportunity in the U.S. market should offer U.S. banks national treatment and competitive equity in their market.

In the Uruguay Round negotiations, NAFTA discussions, and bilateral negotiations, U.S. officials have impressed upon other countries the importance of providing equality of competitive opportunity to U.S. banks and they will continue to do so. The agencies recognize that it is important to assure that U.S. negotiators have the necessary tools to advance U.S. interests abroad. However, the agencies agree that a subsidiary requirement applied to all foreign banking operations either across-the-board or for purposes of expanded powers is not desirable even in this context.

# APPENDIX A

**APPENDIX A**

As shown in Chart 1, foreign banks have been expanding their activities at their U.S. offices, both in absolute amounts and as a share of banking activity in the United States. Between year-end 1980 and June 1992, assets of U.S. offices of foreign banks increased more than three-fold to $860 billion, and their share in the United States market nearly doubled from 12 percent to 23 percent.

Chart 2 provides data on the types of offices at which foreign banks conduct their U.S. activities. At mid-year 1992, branches and agencies accounted for over four-fifths of the assets of all foreign banks. Commercial bank subsidiaries accounted for almost one-fourth of foreign bank activity at year-end 1980; by June 1992, commercial bank subsidiaries constituted less than one-fifth of the total U.S. office assets of foreign banks.

Chart 3 provides data on the nationality of foreign banks conducting business in the United States. The Japanese banks have been heavily represented in U.S. markets, having by far the largest national share. The Japanese banks' share of total foreign bank activity in the United States peaked in December 1989 at 57 percent, and has declined steadily since then as Japanese banks have retrenched generally in international markets. Canadian, French and Italian bank shares of foreign bank assets have generally been in the 5-10 percent range during this period. British banks' share of foreign bank activity in

U.S. markets has declined by more than one-half during this period largely because of the sale of two large California banks. The Swiss banks' share of foreign bank activity has also declined since 1980. The German banks' share has been between 2 and 3 percent throughout the period.

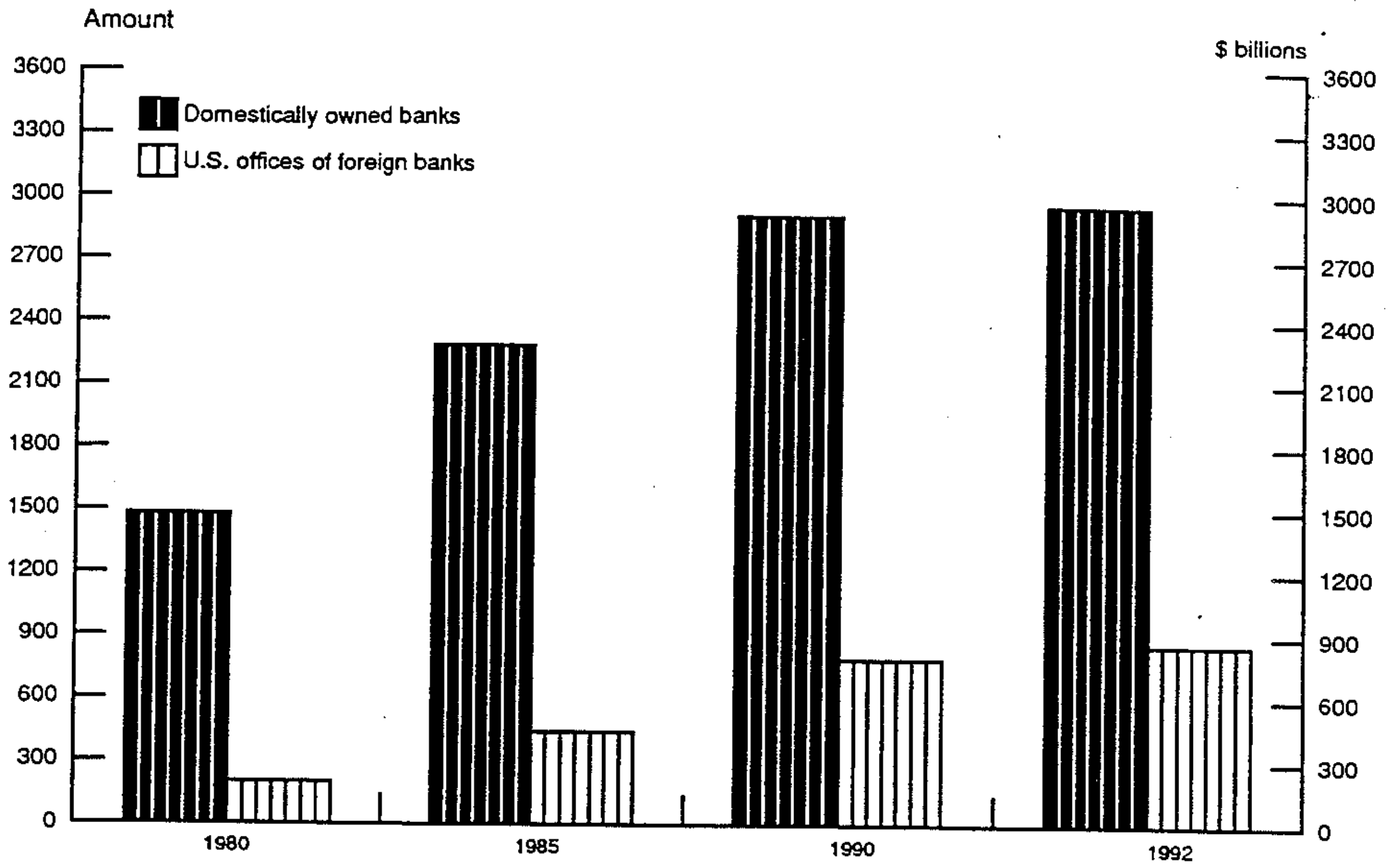
Chart 4 provides data on the growth of foreign bank lending to businesses at their U.S. offices. This lending roughly paralleled the growth of their total assets, increasing more than three-fold during the period to stand at about $210 billion as of June 1992. The foreign banks' share of the market also doubled from 18 to 36 percent. The higher share in business lending by foreign banks reflects the concentration by branches and agencies of foreign banks in wholesale corporate lending rather than other types of lending.

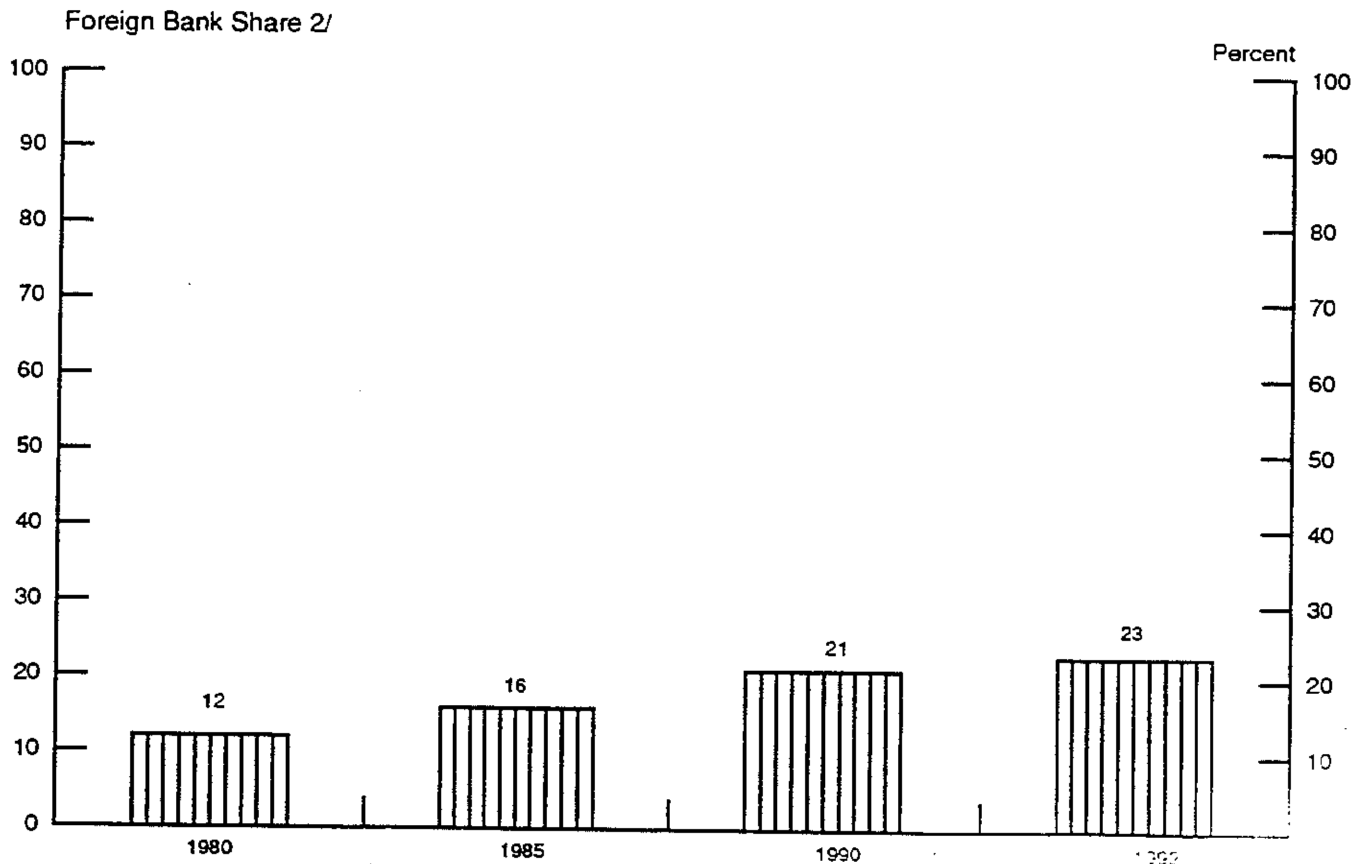
For purposes of comparison, Chart 5 provides historical data on the types of overseas offices of U.S. banks. Similar to foreign banks in the United States, U.S. banks prefer branches to subsidiaries. In recent years, foreign subsidiaries have increased to about one-third of the total assets held by foreign offices of U.S. banks. This share increase reflects several trends, including expansion of retail-based subsidiaries in several countries, the use of subsidiaries by some U.S. banking companies to conduct a broader range of non-banking financial activities overseas, and the reduction in branch activity in overseas interbank eurodollar markets.

Chart 1

December 3, 1992

# FOREIGN BANK ASSETS IN THE UNITED STATES 1/



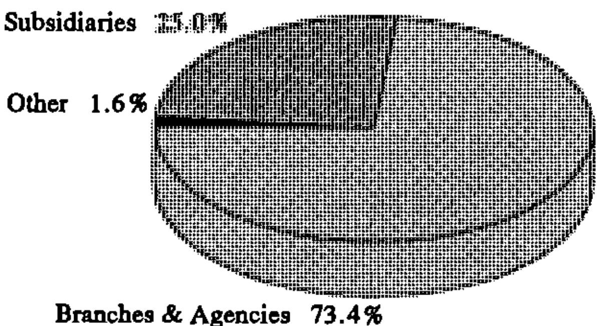



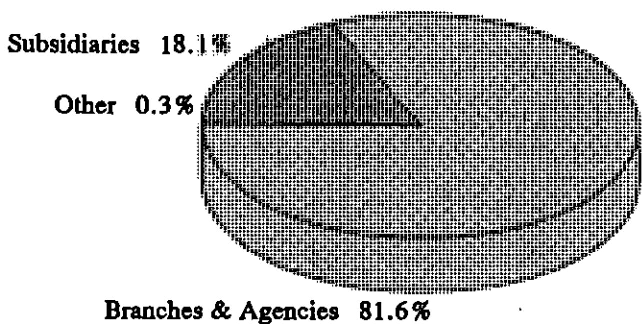

1/ Data for 1992 as of June.
2/ As share of assets of all banking offices in the United States

AMI-ADD-030

Chart 2

# Share of U.S. Assets Held by Foreign Banks: By Type of Office



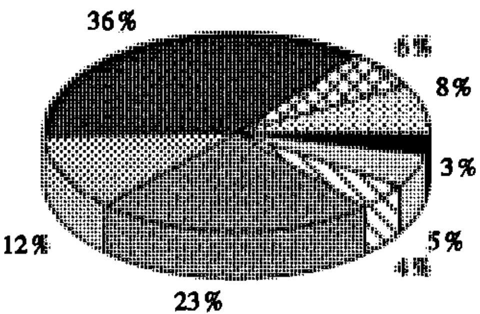




(1) Data for 1992 as of June
Source: Federal Reserve

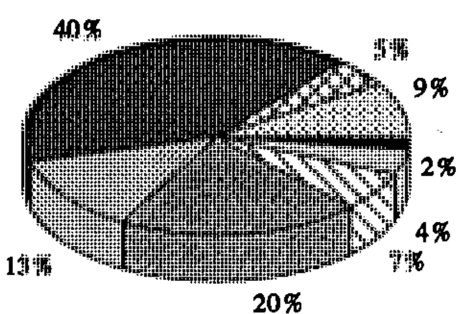
AMI-ADD-031

Chart 3

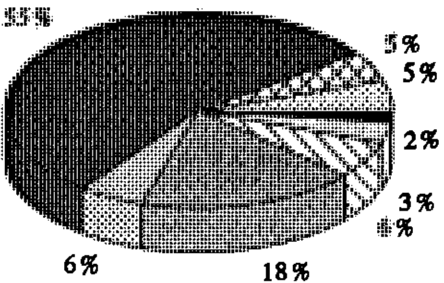
# Share of U.S. Assets Held by Foreign Banks: By Home Country



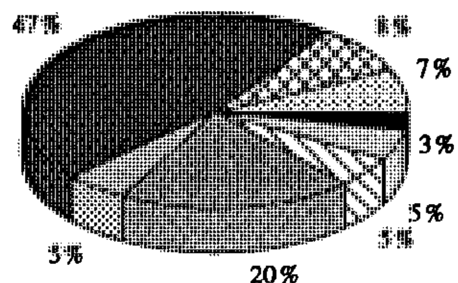

1980




1985




1990




1992 (1)

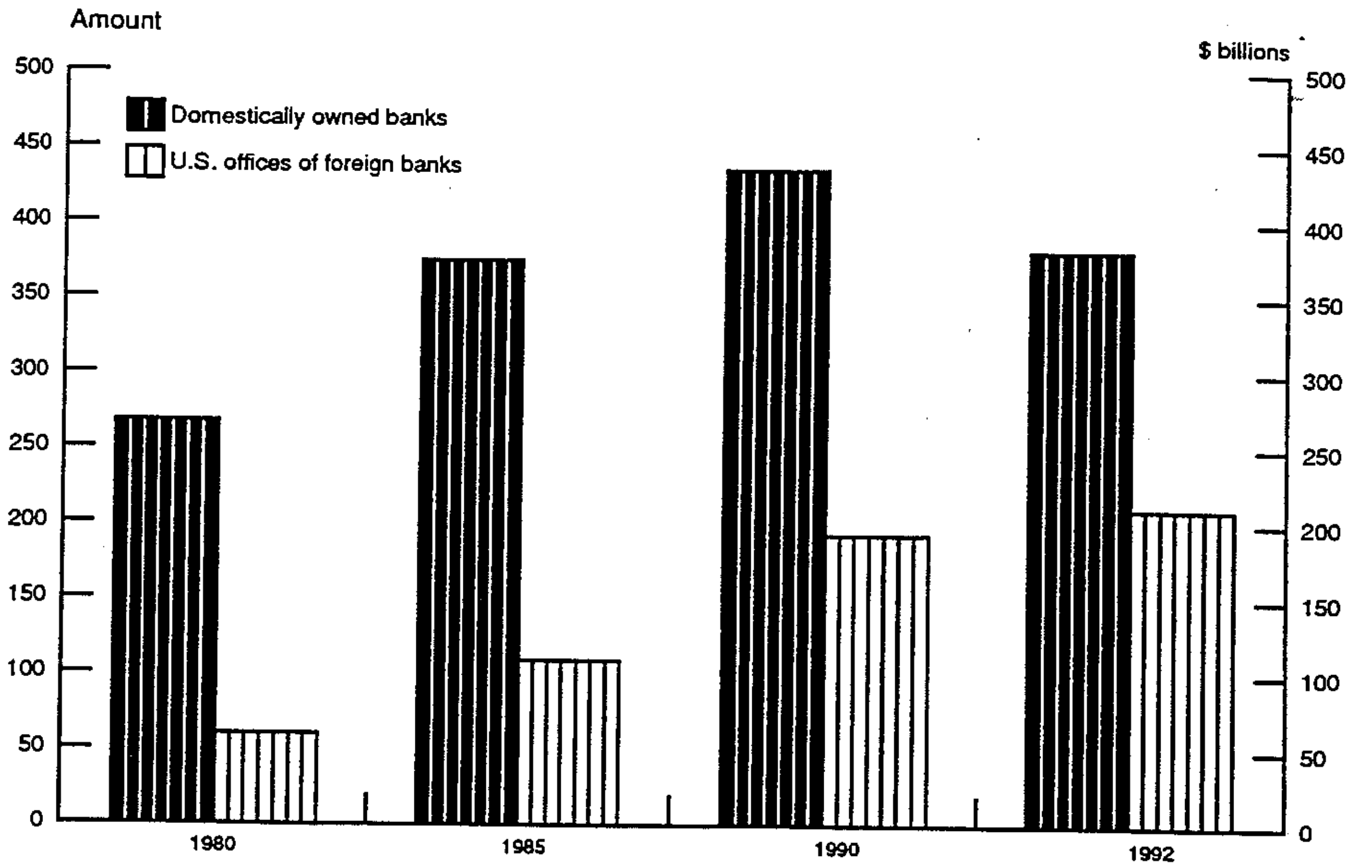
(1) Data for 1992 as of June

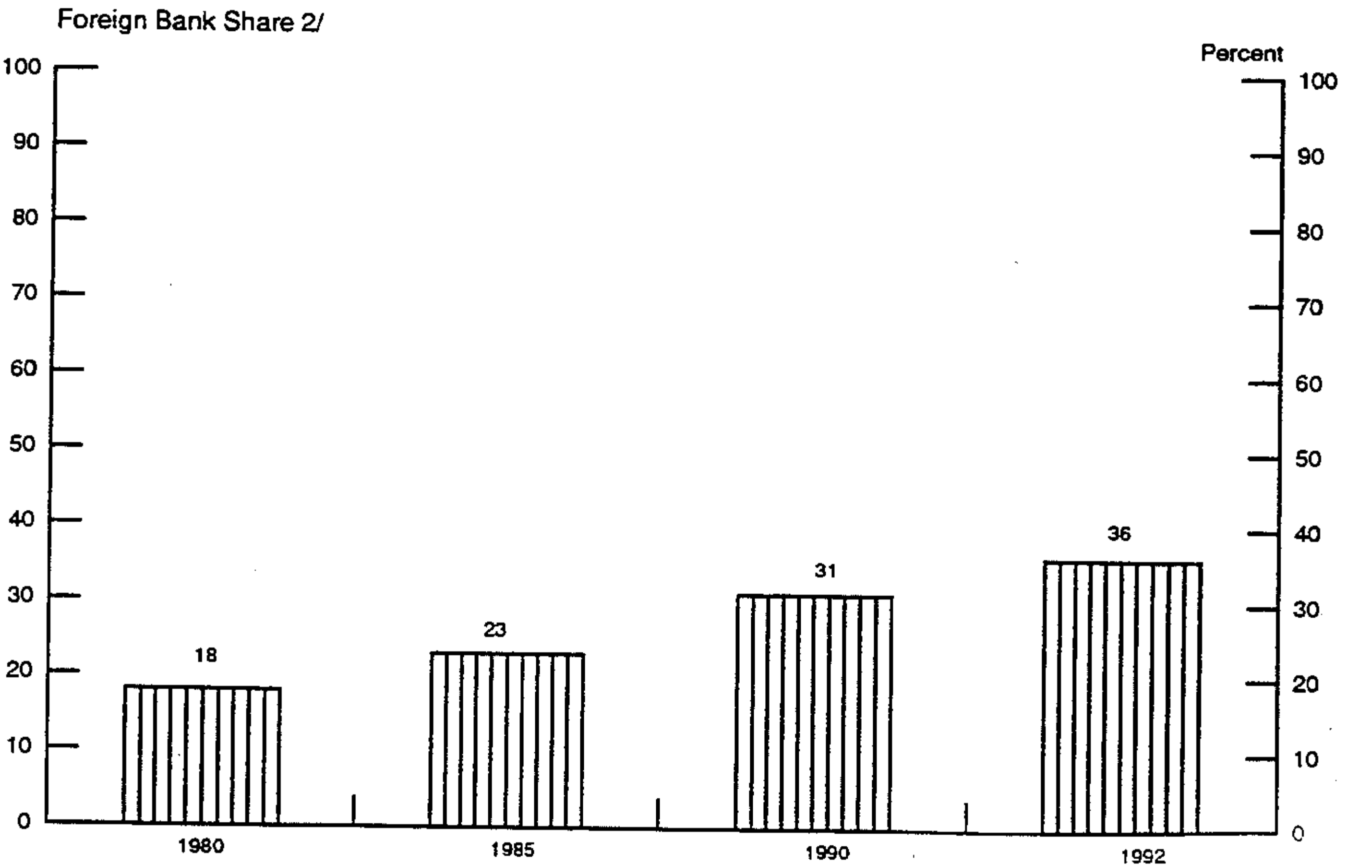
AMI-ADD-032

Chart 4

December 3, 1992

# FOREIGN BANK BUSINESS LOANS AT U.S. OFFICES 1/



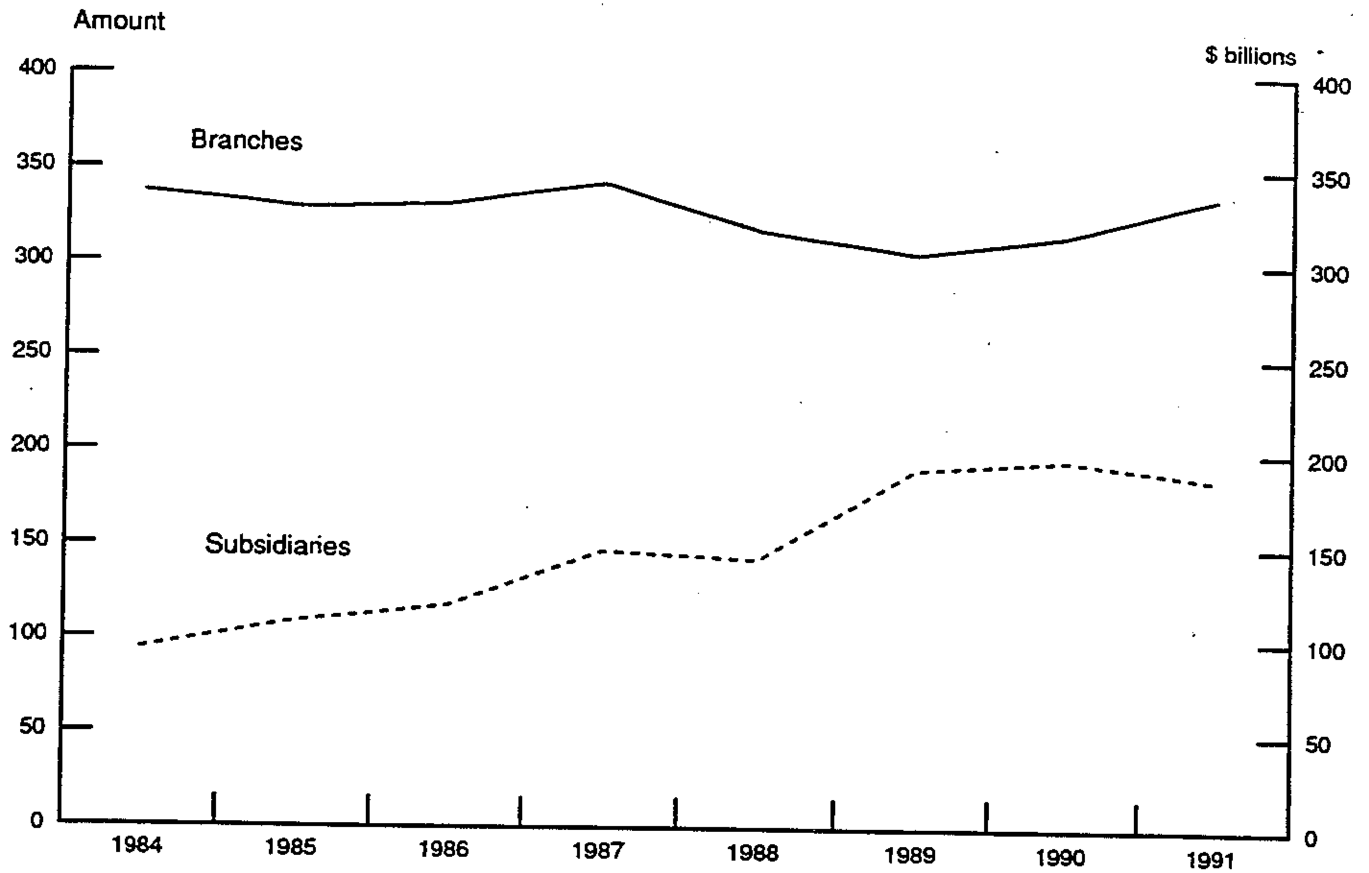

1/ Data for 1992 as of June.
2/ As share of business loans at all banking offices in the United States.

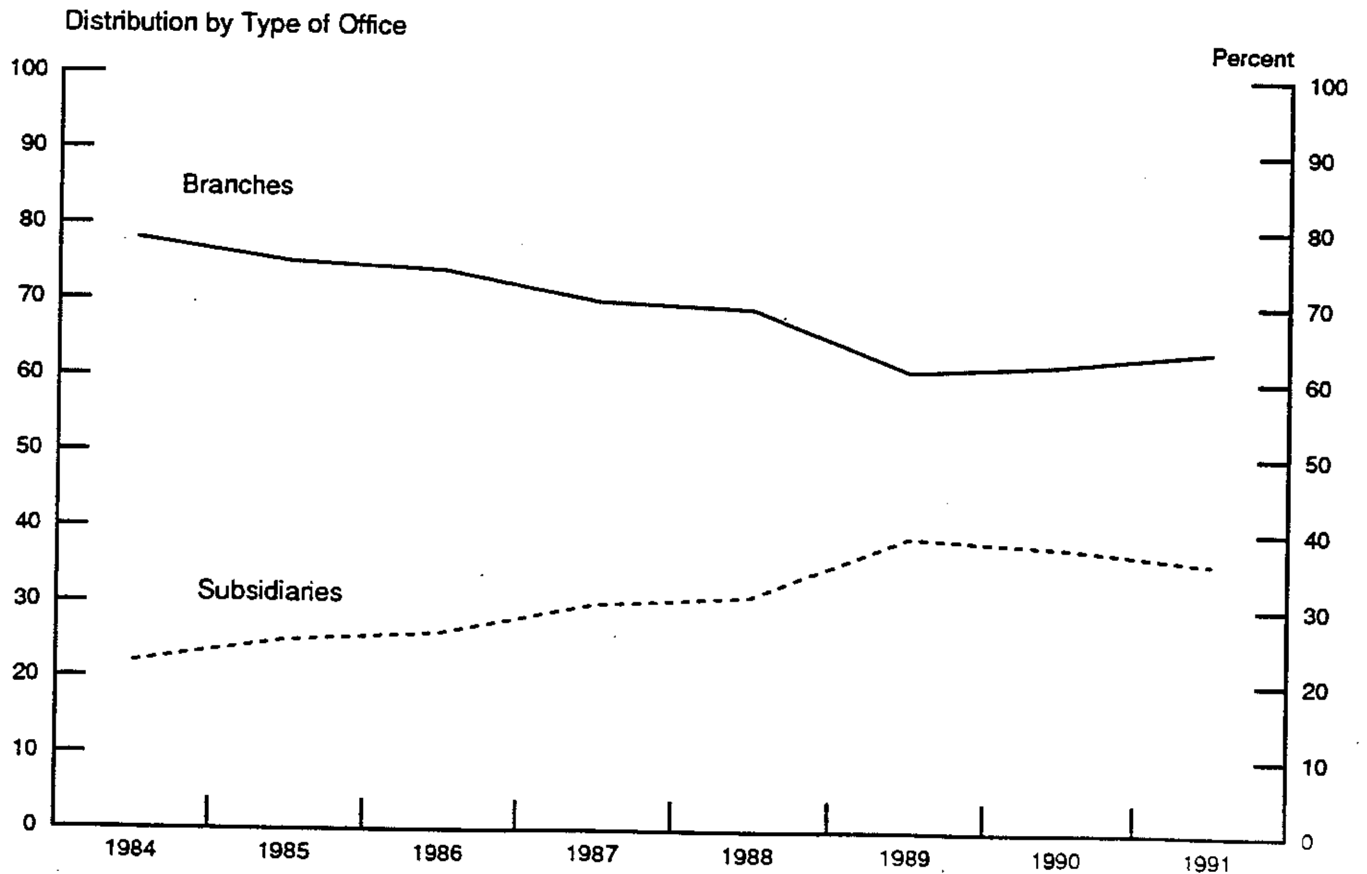
AMI-ADD-033

Chart 5

December 3, 1992

# OVERSEAS OFFICE ASSETS OF U.S. BANKS: BY TYPE OF OFFICE




AMI-ADD-034

# APPENDIX B

**APPENDIX B**

# SECTION 215. STUDY AND REPORT ON SUBSIDIARY REQUIREMENTS FOR FOREIGN BANKS

(a) IN GENERAL. - The Secretary of the Treasury (hereafter referred to as the "Secretary"), jointly with the Board of Governors of the Federal Reserve System and in consultation with the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Attorney General, shall conduct a study of whether foreign banks should be required to conduct banking operations in the United States through subsidiaries rather than branches. In conducting the study, the Secretary shall take into account -

(1) differences in accounting and regulatory practices abroad and the difficulty of assuring that the foreign bank meets United States capital and management standards and is adequately supervised;

(2) implications for the deposit insurance system;

(3) competitive equity considerations;

(4) national treatment of foreign financial institutions;

(5) the need to prohibit money laundering and illegal payments;

(6) safety and soundness considerations;

(7) implications for international negotiations for liberalized trade in financial services;

(8) the tax liability of foreign banks;

(9) whether the establishment of subsidiaries by foreign banks to operate in the United States should be required only if United States Banks are authorized to engage in securities activities and interstate banking and branching; and

(10) differences in treatment of United States creditors under the bankruptcy and receivership laws.

(b) REPORT REQUIRED. - Not later than 1 year after the date of enactment of this Act, the Secretary shall transmit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives a report on the results of the study under subsection (a). Any additional or dissenting views of participating agencies shall be included in the report.

# APPENDIX C

# REGULATORY IMPLICATIONS

# REGULATORY PRACTICES AND SAFETY AND SOUNDNESS CONSIDERATIONS (FACTORS 1 AND 6)

**APPENDIX C**

# REGULATORY PRACTICES AND SAFETY AND SOUNDNESS CONSIDERATIONS (FACTORS 1 AND 6)

## I. SUBSIDIARY VS. BRANCH: REGULATORY PRACTICES

Pursuant to federal banking laws[1], the Board of Governors of the Federal Reserve System ("the Board") and the Office of the Comptroller of the Currency ("the OCC") are required to evaluate, among other things, the financial and managerial resources of foreign banking organizations that apply to acquire a subsidiary bank or establish a branch or agency. Whether the application relates to the acquisition or establishment of a bank or the establishment of a branch or agency, the Board and the OCC evaluate applications by foreign banking organizations under the same set of general criteria relating to financial and managerial strength. The application process is designed to screen foreign banks in terms of their ability to participate in the U.S. banking market under applicable statutory and prudential standards.

In evaluating the managerial resources of foreign banks applying to acquire a subsidiary bank or establish a branch or agency, the supervisory authorities in the home country are

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[1] International Banking Act of 1978, as amended; Bank Holding Company Act of 1956, as amended. Prior to passage of the Foreign Bank Supervision Enhancement Act of 1991, which amended the International Banking Act of 1978, the Federal Reserve had no formal role in the licensing of branches and agencies of foreign banks by either the Office of the Comptroller of the Currency or any state.

routinely contacted in order to obtain information which bears on the management resources, reputation and standing of the foreign bank. In addition, a general review is conducted of the experience and expertise of the proposed U.S. management and background checks are made.

In evaluating the financial condition of a foreign banking organization, sufficient information is required from the applicant in order to permit an assessment of the financial strength and operating performance of the foreign organization. Factors taken into account include capital, profitability, concentrations of risk, liquidity and asset quality. Differences in accounting and regulatory practices are also generally taken into account. In this regard, information submitted will consist of reports prepared in accordance with local practices together with an explanation and reconciliation of major differences between local accounting standards and U.S. generally accepted accounting procedures.

The issue of capital equivalency was recently examined in a report to the House and Senate Banking Committees that was prepared jointly by the Board and Treasury. (See, Capital Equivalency Report, June 17, 1992.) The detailed findings of that report need not be reiterated here; broadly, however, the report concluded that the minimum capital standard established by the Basle Accord provides a common basis for evaluating the general equivalency of capital among banks from various countries.

Although differences in regulatory practices among supervisors continue to exist, efforts are under way to reduce these differences, to the extent possible. Discussions are currently taking place among various supervisors relating to the convergence of regulatory practices. A recent example of the efforts undertaken by banking supervisors is the minimum standards for the supervision of international banking groups and their cross-border establishments proposed by the Basle Committee on Banking Supervision.

In acting on applications by foreign banks, the Board or OCC, in any event, is required to ascertain that the foreign bank is subject to comprehensive supervision on a consolidated basis by the home country supervisor. This requirement applies whether the foreign bank is seeking to acquire or establish a banking subsidiary or establish a branch or agency in the United States.

Once a foreign bank establishes a U.S. banking presence, that banking operation, whether an agency, branch or subsidiary bank, is supervised and regulated under U.S. rules. Such an operation, whether branch or subsidiary, is expected to maintain records and conduct operations in accordance with U.S. banking and regulatory practices.

For example, regardless of the accounting practices of the foreign banking organization's home country, operations of foreign banks in the United States, whether conducted through a subsidiary bank or a branch or agency, are subject to U.S.

regulatory accounting standards. Individual branches and agencies must also follow U.S. regulatory standards in the preparation of their quarterly reports provided to the federal banking regulators (Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks - FFIEC 002). Similarly, branches and agencies are expected to have internal controls and operating procedures that meet U.S. standards. These procedures are subject to examination and, where necessary, U.S. banking authorities can and have used their supervisory powers to force remedial action. The basic standards applied to branches and the range of regulatory powers available to assure compliance with U.S. rules broadly compare to those applicable to subsidiary banks.

## II. SUBSIDIARY VS. BRANCH: SAFETY AND SOUNDNESS CONSIDERATIONS

Safety and soundness can be defined essentially as the extent to which depositors and creditors can be assured that a bank is being operated in a manner that does not expose them to undue risk of loss. Safety and soundness also encompasses a consideration of the risk of loss to the federal deposit insurance fund in the event that the FDIC has to reimburse insured depositors. For a bank with a large volume of insured deposits, substantial risk is borne by the insurance fund. On the other hand, for an institution that accepts primarily uninsured deposits, to the extent that losses exceed capital, losses would be absorbed by depositors and other creditors.

In addition to the concern that banking institutions be operated in such a way as to prevent losses to depositors or to the insurance fund, there is also the potential that an institution could operate outside the bounds of the law, such as by engaging in money laundering or other illicit activities. Thus, safety and soundness further encompasses the principle that an institution operates in compliance with the law. Considerations related to legal compliance are discussed fully in the paper on Factor 5 regarding the need to prohibit money laundering and other illegal payments. Generally, this review found that there are no significant differences between the branch and subsidiary form of organizational structure with respect to compliance with the law. Both types of operation are examined and are subject to enforcement actions and penalties for violations of the law.

There are a number of theoretical advantages and disadvantages, from a safety and soundness standpoint, associated with the two basic forms of organization for U.S. operations of foreign banks. These advantages and disadvantages are embodied in the legal and regulatory differences between branches and subsidiaries, which affect the way they operate. A discussion of the characteristics of each form of organization is provided below. For purposes of this discussion, it is assumed that

branches of foreign banks do not accept retail deposits and, thus, do not have deposit insurance.[2]

**Comparison of Branches and Subsidiaries**

A subsidiary of an organization is a legal entity separate from its parent. Generally, the actions of a subsidiary are not attributed to its parent. As a result, the parent is not legally required to support the subsidiary's operations or to meet its obligations. There is, however, no legal distinction between a branch of an organization and the organization as a whole. Generally, obligations of a branch are obligations of the organization.

In considering the implications for bank safety and soundness of the subsidiary form of organization, one view is that a subsidiary is more insulated, at least in terms of corporate form, from the rest of the parent organization than a branch and has its own capital base to absorb losses. The extent to which a subsidiary bank may engage in transactions with the parent bank is more closely controlled than are branch relations with the bank, thereby reducing potential concentrations of exposure to the parent and related entities. Also, a subsidiary bank's single borrower lending limit is based on the subsidiary

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[2] Insured branches of foreign banks in the United States currently represent a very small sub-set of the total U.S. branches and agencies of foreign banks. Due to recent legislative changes, while existing insured branches have been grandfathered, generally no new insured branches may be established. For this reason, this paper will focus upon uninsured branches of foreign banks.

bank's own level of capitalization and is often quite small in relation to the total resources of the parent. However, subsidiary banks must obtain deposit insurance, which may have the effect of reducing market discipline. (See separate paper addressing considerations related to deposit insurance.)

A subsidiary, by virtue of its separate corporate existence, however, is denied the benefit of being an integral part of a larger, more diversified banking institution. Although theoretically a local bank subsidiary of a foreign parent bank can operate profitably as a stand-alone entity without the benefit of direct access to its parent's funding, support and name, this access in reality is often critical to the subsidiary's survival of a downturn in its market. A parent institution could, under the law, allow a subsidiary to fail without providing additional support. In practice, it is likely that only in extremis would a banking institution with international operations allow a subsidiary to fail, in view of the potentially harmful effect this would have on the parent bank's market reputation and its ability to obtain funding in other markets.

On the other hand, collapse of the parent bank can cause serious difficulties for a subsidiary, including liquidity problems, to the extent that there is market identification of the subsidiary with the parent bank. The strength of its parent, therefore, continues to be a highly relevant consideration for

supervisors in assessing the safety and soundness of even a separately capitalized subsidiary bank.

Under the branch form of organization, the U.S. office functions not as an independent entity but rather as an integral part of the parent organization, which serves as a direct source of funding and support for the U.S. office. While not necessarily diversified themselves, branches also benefit from the overall diversification of the consolidated organization. Using this form of organization, a bank may enhance its overall profitability through the use of branches that carry out particular functions within the organization or serve specific markets. For example, since transactions with the parent are not restricted, those business functions that require significant volumes of intercompany transactions, such as dollar clearing and global trading functions, are often carried out through branches. The lack of restrictions on transactions with the foreign parent also facilitates the transfer of funds within the organization, both to provide support when needed and to take advantage of opportunities to maximize overall profits. Finally, a branch's lending limit is based on the consolidated capital of the foreign bank parent.

A branch's safety and soundness, however, is directly linked to that of its parent. A branch cannot survive as an independent operating entity if its parent bank fails. In addition, deposits placed with a branch are ultimately deposits with the foreign parent and are subject in large part to the

country risk of the parent bank. Branches normally fund their operations by accessing the wholesale markets and depositors operating in these markets are expected to recognize these risks and make investment decisions accordingly, which imposes market discipline upon branches seeking such funding.

While there are these general distinctions between branches and subsidiaries, bank supervisory authorities in some countries have taken steps to make foreign bank branch and subsidiary operations more alike. For example, German supervisory authorities have established "dotation" capital requirements for branches of foreign banks, under which branches are required to maintain a "capital" position. Credit extended and participations held by the branch are limited to a specified amount of this "capital."

Some state supervisors in the United States have employed a different approach by imposing "asset maintenance" requirements upon certain individual banks that are experiencing financial weakness or are from countries whose currencies or economies are considered to be unstable. Under asset maintenance requirements, a branch or agency is required to maintain assets that exceed third-party liabilities by a certain stated percentage.

Federal branches and agencies of foreign banks are required to maintain a "capital equivalency deposit" (CED) with a Federal Reserve member bank in the amount of five percent of the branch's (or agency's) third party liabilities. U.S. federal

bank regulatory authorities also have the authority under existing law to restrict branch operations in appropriate cases in such a way as to provide additional protection to local depositors and creditors by, for example, introducing asset maintenance requirements.

Another possible way to make a foreign bank's branch operations more similar to subsidiary operations is to place limits on transactions with the foreign parent, such as by subjecting the branch operations to limitations on transactions with affiliates similar to those contained in section 23A of the Federal Reserve Act. In the United States, however, such prudential requirements have not had the effect of requiring the branch to operate as a subsidiary in the conduct of its business operations.

Asset maintenance requirements, restrictions such as those required under Section 23A of the Federal Reserve Act, and other supervisory actions can and have been used by U.S. regulators to impose restrictions in particular cases, when believed to be necessary to deal with specific problems for safety and soundness purposes. These restrictions have the effect of insulating the financial condition of the branch or agency from that of the rest of the organization in much the same manner as the incorporation of a separate subsidiary.

However, while useful in dealing with specific problems, imposition of prudential requirements across the board in ways that would limit business operations would effectively

prevent branches from functioning as intended within the operating plans of the respective foreign banking organizations and would risk the relocation of their business outside the United States. Such an approach could also have further negative repercussions in that bank regulators abroad could subject U.S. banks' overseas operations to similar requirements.

In any event, there have been very few instances where foreign banks with U.S. operations have failed or where the U.S. operations of a foreign bank have required rescue. Those instances that have occurred in recent years have resulted in no losses to either depositors or creditors of the U.S. operation, whether in a branch or subsidiary form. (For further discussion of these matters, see separate paper on bankruptcy.)

**Conclusion**

Our experience to date has shown that the U.S. operations of foreign banks can be operated safely under either the branch or the subsidiary form of organization. Instances of failure, with respect to either the parent or the U.S. operation, have been very few and, where they have occurred, have been resolved without loss to either insured or uninsured depositors or to the deposit insurance fund. This has been the result with respect to both the branch and subsidiary form of organization.

The issues raised in the Report to the Senate Committee on Foreign Relations from Senators Kerry and Brown, dated September 30, 1992, regarding a subsidiary requirement were considered at length during the course of this study. Although

there are theoretical advantages and disadvantages with respect to safety and soundness considerations under the two forms of organization, these distinctions are primarily associated with differences in the way the two forms of organization operate and do not support a conclusion that one form is inherently more safe and sound than the other. The ongoing convergence of supervisory standards, including those relating to the comprehensive supervision of banking organizations operating internationally, should enhance the ability of supervisors to monitor and enforce principles of safe and sound operation for all types of U.S. operations of foreign banks.

# IMPLICATIONS FOR THE DEPOSIT INSURANCE SYSTEM (FACTOR 2)

**APPENDIX C**

# IMPLICATIONS FOR THE DEPOSIT INSURANCE SYSTEM

## I. SUMMARY AND CONCLUSIONS

The direct, short-term implications for the U.S. deposit insurance system of requiring foreign banks to conduct banking operations in the United States through subsidiaries, and not branches, are: (1) the deposit insurance assessment base and, consequently, the assessment income of the Federal Deposit Insurance Corporation ("FDIC") are likely to increase; (2) the amount of deposits covered by the FDIC and, therefore, the contingent liabilities of the FDIC are likely to increase; and (3) the risk exposure of the FDIC is likely to increase in response to changes in the structure of the U.S. banking system and the enhanced ability of a foreign bank parent to restrict or withhold support from a separate subsidiary.

It is not possible to quantify the impact of these changes on the deposit insurance system because the subsidiary requirement could create an incentive for foreign banks to move their current operations outside of the United States. As a result of the requirement, foreign banks would be likely to restructure their balance sheets, probably by reducing their assets and liabilities in the United States, to lessen insurance costs (and other costs of operating a subsidiary). The longer term implications of the subsidiary requirement depend on whether the requirement strengthens or weakens the structure and condition of the U.S. banking system as any changes in the

banking system may affect the risk exposure of the deposit insurance fund.

## II. ANALYSIS

This analysis is divided into three sections: (A) Background, (B) Current Law, and (C) Implications of Change.

### A. Background

As of June 1992, foreign banks operated 382 branches in the United States. These branches held aggregate liabilities of $598 billion, or 18.7 percent of the total liabilities held by FDIC-insured commercial banks. As of the same date, 52 branches had FDIC insurance and held $10.1 billion in assets and $4.1 billion in deposits (excluding international banking facility ("IBF") deposits).[1]

U.S. branches of foreign banks generally focus on wholesale banking activities more so than most U.S. banks. As a result, these branches rely more heavily on borrowed funds and on other funds that are not subject to FDIC insurance assessments than U.S. banks do generally. For example, as of June 1992, deposits accounted for 54% of liabilities of U.S. branches of foreign

[1] In addition, 220 agencies of foreign banks held total liabilities of $101.2 billion on that date. The main difference between branches and agencies is that agencies may only accept "credit balances" received in connection with the customer's other business with the agency, and not deposits, from U.S. citizens or residents.

banks, as compared with 83% of the liabilities of FDIC-insured U.S. commercial banks.[2]

U.S. branches of foreign banks also make extensive use of international banking facilities (IBFs)[3]. IBFs were first authorized for use by all banks in 1981 to attract Eurocurrency business, which is a wholesale banking activity, by allowing banks to conduct a deposit and loan business with foreign residents free from reserve requirements and FDIC insurance assessments. Only time deposits that originate from foreign sources, other IBFs or sister offices, and generally that have a minimum transaction size of $100,000, may be placed in IBFs. As of June 1992, U.S. branches of foreign banks held more than half (56 percent) of their deposits in IBFs.

**B. Current Law**

The Federal Deposit Insurance Act ("FDI Act") requires the federal deposit insurance system, administered by the FDIC, to insure up to $100,000 of the deposits held by each depositor at an insured depository institution. 12 U.S.C. § 1821(a)(1). Insurance coverage of a U.S. bank extends both to retail and

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[2] This relatively low percentage of deposits to total liabilities may even understate the wholesale orientation of foreign bank branches. A large proportion of foreign branch deposits are in fact funds due to banks and, in response to a subsidiary requirement, could be converted to term federal funds or to borrowings to avoid FDIC assessments.

[3] Both U.S. banks and U.S. offices of foreign banks are permitted to establish IBFs, which consist of asset and liability accounts segregated on the books of the bank that has established the IBF. An IBF is not a separate entity from the bank.

wholesale deposits once an institution is insured; deposits held in an insured branch of a foreign bank receive insurance protection only if received from a U.S. citizen or resident unless the FDIC determines otherwise. 12 U.S.C. 1813(m)(2).

Insured institutions must pay semi-annual assessments to the FDIC for deposit insurance.[4] Under the current insurance system, an institution's assessment equals one-half of the "assessment rate" multiplied by the institution's "average assessment base". The FDIC recently increased the assessment rate from $0.23 per $100 of deposits to an average of $0.254 per $100 of deposits. The assessment base for insured branches of foreign banks is essentially the same as for an insured U.S. bank, i.e., domestic deposits reduced for float.[5] The assessment base includes neither deposits held in IBFs nor deposits held by U.S. offices of Edge and agreement corporations, as these are not domestic deposits. An institution's average assessment base equals the average of an institution's assessment base on the two semi-annual dates that call reports (FFIEC 031) are submitted.

U.S. branches of foreign banks were not eligible for federal deposit insurance until the enactment of the International Banking Act of 1978 ("IBA"). The IBA originally required any branch of a foreign bank that accepted deposits of less than

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[4] Section 7 of the FDI Act governs the current deposit insurance assessment system, and includes details on the computation procedures. 12 U.S.C. § 1817.

[5] Domestic deposits are demand deposit liabilities and time and savings deposit liabilities held in domestic offices of banks in the United States, its territories, and its possessions.

$100,000 that are domestic retail deposits as determined by the FDIC, or by the Office of the Comptroller of the Currency in the case of federal branches, to obtain deposit insurance. 12 U.S.C. § 3104(a), (b). The Foreign Bank Supervision Enhancement Act of 1991 ("FBSEA") extended this restriction by requiring foreign banks to conduct domestic retail deposit taking activities requiring deposit insurance protection only through an insured bank subsidiary. 12 U.S.C. § 3104(c). As a result, foreign banks cannot generally establish new insured branches to conduct such activities. Existing insured branches are grandfathered.[6]

**C. Implications of Imposing a Subsidiary Requirement**

Requiring branches of foreign banks to roll-up their operations into subsidiaries will affect the assessment base, assessment income, liabilities, and risks of the deposit insurance system. Assuming U.S. branches of foreign banks converted to subsidiaries without changing their liability structure, the assessment base of the FDIC would increase by the amount of non-IBF deposits then held in all uninsured foreign bank branches. As of June 1992, these deposits amounted to $129.3 billion, or about 5.5 percent of the $2,353 billion in assessable deposits in all FDIC-insured commercial banks. At the new annual average assessment rate of $0.254 per $100 of

[6] The FBSEA originally raised an issue as to whether a foreign bank must form an insured subsidiary to accept any type of deposit that is less than $100,000, rather than just domestic retail deposits. Congress clarified in legislation enacted on October 28, 1992 that a subsidiary is only required for domestic retail deposit-taking activities.

deposits, the assessment income of the FDIC would increase by $341 million, or 6.0 percent of the 1991 assessment income of $5.2 billion.[7]

It is unlikely, however, that the assessable deposits or income of the FDIC would actually increase by these amounts. Increases in the assessment base and income of the FDIC would depend on the willingness of foreign banks (or their depositors if increased costs are passed on by the foreign banks) to pay the FDIC assessments. Foreign banks have several permissible options for restructuring their operations to avoid incurring the additional costs of deposit insurance premiums. Foreign banks could simply close their U.S. branches and move some or all of their U.S. operations offshore. Any business that foreign banks could not move offshore might shift to U.S. banks.[8] The foreign banks that form U.S. subsidiaries might restructure their funding requirements to types of liabilities, such as borrowings, that are not subject to FDIC premiums. The latter practice is often used by U.S. banks. Either of these restructuring measures would be relatively easy to implement because a large portion of the current deposits of foreign bank branches are from other banks or are foreign in origin.

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[7] The 1991 assessment income was based on an assessment rate of $0.23.

[8] The U.S. business of branches of foreign banks that shifted to U.S. banks might, in turn, be transferred to the offshore branches of these banks, thus remaining outside the FDIC's assessment base.

The sensitivity of the funding decisions of banks with wholesale operations -- including U.S. branches of foreign banks -- to small changes in relative costs has been clearly demonstrated on numerous occasions. The most recent example occurred in late 1990 with the reduction in reserve requirements. Prior to this reduction, reserve requirements created an incentive for U.S. branches and agencies to obtain funds in the Eurodollar market at 0.05 to 0.10 of a percent less than the cost of booking large time deposits in the United States.[9] When the reserve requirements were reduced, this small yield-spread vanished and large time deposits at U.S. branches and agencies of foreign banks more than doubled, from $60 billion to $130 billion, in the first half of 1991.

The assessment of an insurance premium resulting from the subsidiary requirement would also add to the cost of booking deposits in the United States. This assessment, which would be similar to a reserve requirement of approximately 0.254 percent, would be roughly three times the size of the previous reserve requirement. The insurance premium would almost certainly cause U.S. branches of foreign banks to curtail or even to cease their acceptance of deposits in the United States.

The subsidiary requirement would also affect the costs and risks of the deposit insurance system. A risk-based assessment

[9] Reserve requirements specify the fraction of various categories of U.S. deposits banks must hold in vault cash or in non-interest bearing accounts with the Federal Reserve. Interest foregone on such reserves has been compared to a tax on banks.

system would appear to be easier to implement for subsidiaries than for branches, at least in principle. The information available on a subsidiary would seem to be more meaningful for evaluating risk than that available on a branch, since a subsidiary is a separate legal entity, while a branch is an integral part of its parent. In practice, however, a subsidiary requirement would not simplify implementation of the risk-based assessment system in this manner. As discussed in the Safety and Soundness portion of this study, the financial strength and risks of the parent are relevant to the risks of a subsidiary, as well as a branch, and require evaluation in both circumstances.

A subsidiary requirement could reduce the risk exposure of the deposit insurance system if it simplified supervision and, in the event of failure, liquidation. With respect to supervision, U.S. regulators may seem to have more control over a U.S. incorporated subsidiary bank (at least over those activities that are not moved offshore) than over a U.S. branch of a foreign bank. However, under the FBSEA, supervisors were granted similar statutory powers with regard to U.S. branches and agencies of foreign banks as U.S. banks. See also "Safety and Soundness," Factor 6.

With respect to liquidation, while receivership might appear easier to administer for a subsidiary than for a branch of a foreign bank, there might equally be advantages to liquidating a branch rather than a subsidiary. Requiring a foreign bank to operate only through a subsidiary places a legal shield between

the parent foreign bank and its U.S. operations. Although a foreign bank is already liable for the operations of its branches, a foreign bank's liability for its subsidiary is limited by law to the capital invested and to any guarantees of the subsidiary's liabilities. Thus, in a liquidation, a foreign bank could withdraw support more easily from a subsidiary. This potential may increase risks to the deposit insurance system.

The FDIC has no experience in liquidating an insured branch of a foreign bank. Its only experience in closing an office of a foreign bank consists of the liquidation of an insured subsidiary of a foreign bank. In this case, in contravention of U.S. law, the U.S. subsidiary transferred assets to its parent. The FDIC eventually recovered the assets, but only after a protracted struggle.

Only a few branches and agencies of foreign banks have been liquidated by other U.S. bank regulators since foreign banks began operating directly in the United States in 1945. In these few liquidations, all U.S. creditors, including depositors, were paid in full.

# APPENDIX D

# NATIONAL TREATMENT/ FINANCIAL SERVICES IMPLICATIONS

# NATIONAL TREATMENT/ COMPETITIVE EQUITY CONSIDERATIONS (FACTORS 3, 4 AND 9)

**APPENDIX D**

# NATIONAL TREATMENT/COMPETITIVE EQUITY CONSIDERATIONS (FACTORS 3, 4 AND 9)

## I. MEANING OF "NATIONAL TREATMENT" AND "COMPETITIVE EQUITY"

"National treatment" is based on the principle of nondiscrimination between domestic and foreign firms. This policy has generally been followed by the United States with respect to many sectors and has been subscribed to through different mechanisms. The Friendship, Commerce and Navigation Treaties of the United States and the OECD National Treatment Instrument define national treatment as treatment under host-country laws, regulations and administrative practices "no less favorable than that accorded in like situations to domestic enterprises." The expression "no less favorable" is meant to allow for the possibility that exact national treatment cannot always be achieved. Although not established by statute, national treatment has been the U.S. attitude toward foreign direct investment since World War II. The International Banking Act of 1978 (IBA) applied this policy to the treatment of foreign banks in the United States.

Both in applying the concept of national treatment to foreign banks in the United States and in evaluating the treatment of U.S. banks abroad, the United States has attempted to ensure that national treatment means <u>de facto</u> not just <u>de jure</u> national treatment. Thus, the U.S. position has been that national treatment must be interpreted in a meaningful, common-

sense way, as opposed to a rigid, mechanical application of host-country rules.

Consistent with this approach, over the years the U.S. Government has used several additional terms to elaborate upon the concept of national treatment. These include "competitive equity," "equality of competitive opportunity" and "same competitive opportunities." These terms have been helpful elaborations for financial policy-makers in consideration of the U.S. policy of national treatment, especially in light of an alternative interpretation that views identical treatment as consistent with national treatment, even though identical treatment might nonetheless impose real competitive disadvantages to foreign firms.[1]

For this reason, in the Uruguay Round negotiations on trade in services, it has been acknowledged that national treatment may involve either identical or different treatment of foreign and domestic firms. The treatment would be considered "less favorable" if it modified the "conditions of competition" in favor of domestic over foreign firms.

For purposes of this study, the implications of imposing a subsidiary requirement upon foreign banks will be considered in terms of the standard of de facto national treatment, that is, treatment of foreign banks that could be

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[1] For a discussion of equality of competitive opportunity and the distinctions between de facto and de jure national treatment, see the 1979 Report to Congress on Foreign Government Treatment of U.S. Commercial Banking Organizations, pages 1-3 and 15-18.

identical to or different from the treatment of domestic banks but is no less favorable when all circumstances are taken into account.

In this section, unless indicated otherwise, the term "national treatment" will be used to refer to both establishment and operations of foreign banks.[2]

## II. RECIPROCAL NATIONAL TREATMENT

The Treasury Department believes it is important to note that, in recent years, a number of countries have adopted legislation that incorporates a reciprocal national treatment standard. Pursuant to such legislation, foreign firms could be denied national treatment if the home market of the foreign firm does not offer national treatment to firms of the country concerned. In 1984, 11 OECD members had reciprocity powers available to them. By January 1993, at least 18 of the 24 OECD members will have some form of reciprocity powers available, including Japan, the United Kingdom, and Germany.

The movement towards reciprocity or reciprocal national treatment in many other industrial countries and the slow progress in achieving national treatment and equality of competitive opportunity in some foreign markets have raised the question of whether the United States should change its

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[2] The term "national treatment" refers to the operations of financial institutions but, in specific cases, may not refer to the rights of establishment. For example, the OECD "National Treatment Instrument" does not refer to establishment, which is covered under the OECD Codes of Liberalization.

fundamental policy of national treatment to one of reciprocal national treatment. For example, the United States could consider imposing a subsidiary requirement on banks from countries that do not permit the establishment of branches by U.S. banks. This would affect only a limited number of countries, including Canada, Mexico, Norway, South Africa, and several other Latin American and Asian countries.

The threat that the United States might enforce such a sanction could be sufficient to cause the affected countries to permit entry by branches of U.S. banks. Alternatively, it might compel the country concerned to restrict further access by U.S. banks.

The EC Second Banking Directive also established an EC-wide policy of reciprocal national treatment, which authorizes negotiations with countries that do not provide effective market access comparable to that granted by the Community to credit institutions from a third country. In addition, sanctions are allowed to be imposed upon countries that do not grant national treatment. The Second Banking Directive required member states that did not have reciprocity provisions to adopt them. EC officials indicated that they may eventually seek negotiations with the United States because of disparities in the structure of our respective financial systems and perceived unequal opportunities for EC firms in U.S. financial markets.

## III. REVIEW OF THE TREATMENT ACCORDED FOREIGN BANKS IN THE U.S. MARKET AND U.S. BANKS ABROAD

### A. Foreign Banks in the U.S. Market

As of June 30, 1992, 309 foreign banks from 62 countries had 733 U.S. offices with assets totalling $861 billion, which constitute approximately 23 percent of all banking assets in the U.S. market. More than four-fifths of these assets are held in branches of foreign banks.

The IBA adopted the policy of national treatment, described as parity of treatment between foreign and domestic banks in like circumstances. The United States generally has adhered to such a policy. Exceptions are discussed in Chapter 1 of the 1990 National Treatment Study. Most notably, a minority of states still do not provide national treatment to foreign banks.[3] The 1990 Study acknowledges that denial of equality of competitive opportunity by states "undermines the International Banking Act's (IBA) policy of national treatment."[4]

The United States also has provided better than national treatment in specific cases to foreign banks. Although the IBA extended to branches and agencies of foreign banks restrictions similar to those applied to U.S. banks, the legislation also grandfathered existing U.S. activities of

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[3] Department of Treasury, 1990 National Treatment Study, pages 34-35.

[4] Another exception is the Primary Dealers Act of 1988, which established a limited policy of reciprocal national treatment for the granting of primary dealer status to foreign firms operating in the U.S. government securities market.

foreign banks.[5] Thus, seventeen foreign banks were permitted to retain ownership of their securities affiliates following passage of the IBA.

### B. U.S. Banks in Foreign Markets

U.S. banks are active in a variety of international banking markets. In June 1992, 1,411 U.S. bank offices held $522.1 billion in foreign assets, of which 64 percent are held in foreign branches of U.S. banks.

The 1990 National Treatment Study, which was submitted to Congress by the Department of Treasury, provides detailed information regarding the treatment accorded U.S. banks in twenty-one foreign banking markets, including some in which "significant" denials of national treatment to U.S. banks remain. Most industrialized countries at present permit establishment of branch operations by foreign banks. U.S. banks are also permitted by foreign authorities to engage and compete in various activities abroad, even though they are not permitted to engage in such activities in the United States.

## IV. ADVANTAGES AND DISADVANTAGES OF OPERATING THROUGH BRANCHES VERSUS SUBSIDIARIES IN THE UNITED STATES

This section reviews the various advantages and disadvantages of operating in the United States through a branch as compared to a subsidiary from the perspective of a parent foreign bank. As discussed below, the branch or subsidiary form

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[5] See the 1990 National Treatment Report, pages 34-37 for additional explanation.

of organization has implications for the amount and distribution of the capital of the bank, the management of its liquidity and funding, regulatory and administrative costs, and other factors, such as lending limits, that affect its competitive opportunities in certain markets. Some of the costs associated with organizational form are relatively fixed; others may vary with the size of the operation. The impact of lending limits and other constraints also depends upon the size of the U.S. operation relative to that of the parent foreign bank.

This analysis indicates there can be significant cost savings derived from the branch form of organization. A branch, as compared to a subsidiary, of a foreign bank would also appear to have greater opportunities in highly credit-sensitive wholesale markets. It should be emphasized, however, that additional factors also enter into a bank's decision on whether to pursue the branch or subsidiary form of organization. These factors generally involve the foreign bank's overall strategy and business plan. For example, the subsidiary form is usually chosen if the emphasis is on retail banking, which usually requires a number of offices. In this case, the foreign bank might choose to acquire an existing U.S. bank. The branch form of organization is often chosen if the foreign bank's focus is on wholesale banking, as is typically the focus of foreign banks in the United States.

The analysis set forth here would also apply to foreign banks should they be required to conduct banking operations in

the United States through a subsidiary in order to engage in securities activities or interstate banking and branching.

### A. Capital

#### 1. Amount and Distribution of Capital

The branch versus subsidiary form of operation can affect the efficiency with which the capital of the banking organization is used. The branch form of operation enables the parent bank to deploy its capital flexibly to take advantage of changing profit opportunities in different markets. When competitive opportunities lead to an expansion of activities in the United States, say, the foreign parent can allocate additional capital internally to support this expansion. Should activities of the U.S. branch contract, the parent bank can reallocate this capital to support growth elsewhere in the parent bank organization.[6]

Under a subsidiary structure, capital resources cannot easily be redeployed to respond to changing market opportunities. A subsidiary will need to maintain total capital (tier 1 plus tier 2) equal to at least 8 percent of the subsidiary's risk-

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[6] In the United States federal or, in some cases, state authorities require asset pledges, a form of minimum capital requirement, from U.S. branches of foreign banks. For federally licensed branches, the Comptroller of the Currency requires a capital equivalency deposit to be maintained in a Federal Reserve member bank in the amount of 5 percent of the branch's third party liabilities. State banking authorities may call for asset maintenance requirements, which are satisfied with eligible assets on the books of the branch. Asset maintenance requirements are discussed in the section on Safety and Soundness.

weighted assets, at least half of which must be in the form of tier 1 capital.

Tier 1 capital consists mainly of shareholder's equity and retained earnings. Tier 2 capital may consist of perpetual preferred stock, hybrid capital instruments, subordinated debt (limited to 50 percent of the U.S. subsidiary's tier 1 capital), and loan loss reserves (limited after 1992 to 1.25 percent of the subsidiary's risk-weighted assets).[7] In practice, therefore, the tier 2 capital requirement generally involves the issuance of some capital instruments in addition to the parent's straight equity. If these are purchased by the parent, the effect on the parent's cash position is the same as a straight equity injection. The need for cash from the parent would be reduced to the extent the U.S. subsidiary could sell some of its subordinated debt in the market. A public sale of the subsidiary's debt, however, would usually be undertaken only with the guarantee of the foreign parent (which would reduce the parent organization's total borrowing capacity) in order to avoid paying a premium over the parent's cost of funds. In most cases, the parent would not wish to diminish its ownership interest in the U.S. subsidiary through the public sale of the subsidiary's equity or preferred stock.

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[7] Parent banks in countries that permit undisclosed reserves, revaluation reserves, and latent revaluation reserves to count as tier 2 capital could not transfer portions of these reserves to the United States to satisfy tier 2 capital requirements of U.S. subsidiaries.

The required minimum capital for a subsidiary would also be expected to include an amount to accommodate future growth. The injection of new capital into a subsidiary involves satisfying legal and regulatory requirements in both the home and host country and often entails material tax and administrative costs.

**2. Home Country Capital Requirements**

A subsidiary form of operation may result in a higher overall regulatory capital requirement for the foreign banking organization as a whole. The host country may require the subsidiary to hold additional capital if the subsidiary, due to its small size, is unable to build up a fully diversified portfolio of risk. The home supervisor could also decide to disallow from consolidated capital any portion of the U.S. subsidiary's capital that is not subordinated to the depositors and general creditors of the parent bank.

A number of supervisors, including U.S. supervisors, assess capital adequacy on an unconsolidated (solo), as well as a consolidated, basis; i.e., the capital in a U.S. subsidiary would not qualify as capital of the parent for certain supervisory purposes. A low level of capital as measured on an unconsolidated basis could trigger a supervisory response.

**B. Liquidity and Funding**

For the reasons given below, a subsidiary form of organization is likely to increase the cost of wholesale funding, reduce the availability of interbank credit lines, and decrease

flexibility in the management of liquidity. However, the subsidiary structure may increase access to core retail deposits.

### 1. Wholesale Funding

A bank's ability to sell large denomination CDs depends crucially on its credit standing, which depends, in turn, on its size and financial strength, including capital. Because a branch is an integral part of the parent, a branch's access to these markets is virtually the same as that of the parent bank. A subsidiary is a separate legal entity and has to operate in the market on its own strength, unless it is supported by a formal guarantee from the parent. In most cases, a subsidiary's credit standing is inferior to that of its parent, which diminishes its access to wholesale funding sources or increases the cost of such funds.[8] This differential for a subsidiary as compared with a branch is often accentuated during periods of market unrest or illiquidity.

### 2. Interbank Credit Lines

Similarly, the cost of and access to interbank credit lines also depend crucially on the credit standing of a bank. For the reasons given above, a branch's access to interbank lines on the strength of its parent is usually greater than is available to a subsidiary of the bank. A subsidiary must generally pay more than the parent bank or its direct branches

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[8] A subsidiary would also have to pay insurance premiums on assessable deposits, which would erode its competitiveness in raising funds in the U.S. market for large denomination CDs. See separate paper on deposit insurance implications.)

for interbank credit and the subsidiary's lines are not as large. A subsidiary's funding possibilities compared to those of a branch may also tend to narrow further during periods of market uncertainty or illiquidity. Liquidity support may also be provided to branches, subsidiaries, or the parent bank through possible access to central bank discount window credit in either the home or host country.

### 3. Funding Flexibility and Liquidity Management

Under a branch form of operation, the parent bank can pursue a centralized approach to liquidity management. An important consideration for some parent banks is the extent to which its U.S. operations can be used to meet its overall dollar funding needs. A U.S. branch can either be heavily supported by funds from the parent bank (a "net due to" parent position) or, alternatively, the U.S. branch can be a funding source for the parent (a "net due from" parent position).

Under a subsidiary structure, funding must be conducted for the primary benefit of the subsidiary and not of the parent. A subsidiary will be expected to establish its own liquidity management guidelines and meet its own liquidity needs, both under normal and adverse conditions. This could increase funding costs and would reduce funding flexibility for the parent bank.

Banking supervisors in the United States (as well as in most other countries) impose restrictions on the advancement of funds by a subsidiary to its parent or other affiliates (discussed below under C.3.). As a consequence, in operating

through subsidiaries the parent bank loses flexibility in the management of liquidity, especially dollar liquidity, for the organization as a whole.

#### 4. Retail Deposits

With the passage of FDICIA, foreign banks desiring to raise retail deposits in the U.S. must do so as an insured subsidiary, although previously existing FDIC-insured branches are grandfathered. The importance of core retail deposits to the overall liquidity management and profile of a parent bank will vary, depending on such factors as the bank's strategy and position in other markets.

### C. Activities in the U.S.

#### 1. Limits on Loans to a Single Borrower

A subsidiary's legal lending limit would be based on its capital and surplus, rather than that of its parent foreign bank as would be the case for a branch. For a national bank, this lending limit is 15 percent of the bank's unimpaired capital and surplus for loans that are not fully secured, with another 10 percent permitted if secured by readily marketable collateral. State banks are also subject to legal lending limits based on capital, which vary by state but are generally similar to those that apply to national banks.

The capital of subsidiaries is usually small compared to the capital of the parent, and the capital-related limit on loans to one borrower would likely prevent the U.S. subsidiaries of foreign banks from competing for large loans in the U.S.

corporate sector. The subsidiaries could transfer loans to their parents but often at increased cost or with possible adverse tax consequences (see separate paper on tax implications).

### 2. Trading and Risk-Management Activities

U.S. branches of foreign banks engage in foreign exchange, credit enhancement, and over-the-counter derivative products, such as swaps, forwards, and options, largely on the strength of their parent organizations. Of the "large" banking participants in the U.S. foreign exchange market, as indicated on the monthly consolidated foreign currency report of banks in the United States, 87 are foreign banks, of which 85 conduct these operations through a branch or agency and only two through a U.S. subsidiary bank.[9] The counterparties in these transactions, which are generally other major international banks, are highly credit sensitive and know the branch's commitment is backed by its parent institution. A U.S. subsidiary would generally not be able to participate in these markets as extensively as a branch unless the foreign parent formally guaranteed its activities. Parent guarantees have cost consequences, however, such as raising the parent's required capital or reducing its overall borrowing power.

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[9] The FFIEC 035 foreign currency report is required from U.S. chartered banks, bank holding companies, Edge corporations, and U.S. branches and agencies that report more than $1 billion in commitments to purchase foreign exchange. There are 122 respondents to the 035 Report, of which 35 are U.S. owned banks and 87 are foreign owned or controlled.

### 3. Restrictions on Transactions With Affiliates

Since a U.S. subsidiary bank of a foreign bank is a separately chartered bank, transactions between the subsidiary and the parent bank must be carried out on an "arm's length" basis, which means that such transactions must be treated as if the parent and the subsidiary were not under common ownership. As a result, such transactions may have tax consequences and other costs that would not arise in the case of internal transactions between a parent and a branch.

Section 23A of the Federal Reserve Act, which limits quantitatively the financial transactions between insured banks and their affiliates and requires that such transactions be collateralized, would apply to the U.S. subsidiary of a foreign bank. For example, credit extensions, advances, purchases of assets, or investments in a single affiliate of an insured bank are limited to 10 percent of the bank's equity capital. Other transactions included in the limit are guarantees issued on behalf of an affiliate and the acceptance of an affiliate's securities as collateral for any loan. The total of such credit extensions, investments, and other transactions involving all affiliates is limited to 20 percent of equity capital.

The 23A restrictions on extensions of credit to affiliates, including any intra-day and overnight extensions of credit (even if fully collateralized), would severely hamper a U.S. subsidiary bank of a foreign bank in serving as a funding center for its parent or in providing clearing services for the

parent and other affiliates. Such activities are currently important functions of U.S. branches of foreign banks.

In some cases, exceptions to the 23(a) restrictions have been made to accommodate extensions of credit incidental to clearing services, as in the case of domestic Section 20 subsidiaries.[10] The cost of collateralizing such credit extensions, however, would erode the competitiveness of a U.S. subsidiary bank of a foreign bank in this area of activity.

### D. Regulatory and Legal Costs

The establishment of a subsidiary usually entails greater costs than that generally associated with the establishment of a branch because a subsidiary requires a separate board of directors and management structure, its own system of credit administration and internal controls, and additional legal documentation.

#### 1. Board of Directors and Management Structure

A U.S. branch needs an approved branch manager and other staff as appropriate. A U.S. subsidiary, however, is required to be "self-contained," that is a complete stand-alone entity, and generally must have a complete management staff. There is no separate board of directors for a branch, but a number of requirements apply to directors of national banks. Similar requirements generally apply to state chartered banks.

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[10] See paragraph 21(b) of the 28 firewall conditions (Board Order dated January 18, 1989).

National bank directors normally need to be U.S. citizens, though the Comptroller of the Currency may waive this requirement for not more than a minority of the total number of directors in the case of foreign bank subsidiaries. At least two-thirds of the directors are also subject to other residency requirements. These requirements increase the costs of a subsidiary, whereas for a branch the foreign bank's head office may undertake many functions on its behalf, including planning and logistical support.

### 2. Credit Administration and Internal Controls

A U.S. branch needs to maintain adequate credit files, have adequate internal controls (which may be largely provided by head office), and maintain its records in English.

In addition to the requirements for a branch, a U.S. subsidiary will often have its own, separate credit administration and support and control systems, which will also add to its costs.

### 3. Legal Documentation

For U.S. branches, legal documentation is limited to that necessary to gain approval for establishment of the branch in the United States. Minimal legal documentation is required for most transactions between the branch and its parent (or other affiliates). A subsidiary, however, is separately incorporated and must obtain a national or state banking charter. In addition, the subsidiary is likely to be subject to ongoing legal documentation requirements with regard to transactions with its

affiliates, which would not arise in the case of transactions between a branch and the parent or other branches of the parent.

## V. INTERNATIONAL IMPLICATIONS OF A SUBSIDIARY REQUIREMENT

This subsection examines the international implications of a U.S. requirement that foreign banks roll-up their banking operations in the United States into separate subsidiaries, if such requirements were applied: (1) across-the-board to all foreign banking operations in the United States; or (2) only to those foreign banks that wished to avail themselves of new banking powers in the event that new powers are granted to U.S. banks.

### A. Subsidiary Requirement Imposed upon all Foreign Banking Operations

Introduction of a subsidiary requirement by the United States for all foreign banking operations would necessitate a major restructuring of such operations in view of the preference exhibited to date by foreign banks for the branch form of organization for their U.S. operations. As discussed above, U.S. branches of foreign banks account for more than four-fifths of all U.S. assets held by foreign banks.

Adoption of a subsidiary requirement for all commercial bank activities would reduce the efficiency and competitiveness of international banking markets and thereby decrease the welfare of consumers. Beyond achieving equality of competitive opportunity for foreign and domestic banks, a fundamental purpose of a policy of national treatment is to provide consumers of financial services in a host country with access to as deep,

varied, competitive and efficient a banking market as possible. In other words, a policy of national treatment for foreign banking institutions helps to assure that a host country market is one in which individuals, businesses, and also public sector entities can satisfy their financial needs on the best possible terms.

Introduction of an unqualified subsidiary requirement by foreign countries could also have a substantial adverse impact on U.S. banks, which rely heavily on the branch form of organization for their activities abroad. As discussed above, foreign branches of U.S. banks account for two-thirds of all foreign assets held by U.S. banks. Indeed, branches are by far the preferred form of organization for the conduct of U.S. banking operations abroad. A subsidiary requirement could jeopardize U.S. banks' existing foreign branches by establishing a model to be followed by foreign governments in their own markets, and similarly frustrate future efforts by U.S. banks to establish operations abroad in new markets that could be important to the banks' longer-term competitive position. This possibility is particularly acute in those countries that have a reciprocal national treatment standard. (For further discussion of these issues, see separate paper on Factor 7 -- Implications for International Negotiations for Liberalized Trade in Financial Services.)

In addition, at present, U.S. banks are permitted by foreign authorities to engage and compete in various activities

abroad, even though they are not permitted to engage in such activities in the United States. Foreign authorities could also choose to reconsider such favorable treatment in the light of the imposition of a subsidiary requirement.

Such a wide-ranging subsidiary requirement would also undermine longstanding U.S. efforts to encourage countries such as Canada to drop their own subsidiary requirements. In addition, it might encourage other countries to introduce such requirements. At present, most industrialized countries do not have requirements prohibiting the establishment of branch operations by foreign banks.

The motivation for an across-the-board subsidiary requirement would also be inconsistent with the framework adopted by the Basle Committee of Banking Supervisors, which recognizes that banks operate internationally through branches and which consequently has sought to strengthen the supervision exercised over branches of foreign banks by stressing the primary role and responsibilities of the home country (i.e., the country of incorporation of the foreign bank) supervisor, as well as host country responsibilities. Neither Treasury nor the Federal Reserve Board believe that such an unqualified subsidiary requirement is warranted.

### B. Subsidiary Requirement Imposed in Connection with New Powers

The question has also been raised as to whether a subsidiary requirement should be imposed with regard to the

banking operations of foreign banks in the United States if U.S. banking organizations are granted new powers to engage through separately incorporated subsidiaries in securities activities or interstate banking and branching.[11] Under this type of approach, only those foreign banks that wished to avail themselves of the expanded powers would be required to restructure their branch operations into subsidiary form.

The Administration's 1991 financial modernization proposal,[12] which ultimately was not enacted, was broadly along these lines. Under this proposal, new powers would have been authorized to those U.S. financial services holding companies with "well-capitalized" banks. Foreign banks that wished to obtain expanded powers (which under the 1991 proposal included securities and insurance activities) were required to "roll-up" all existing branch and agency operations into one or more well-capitalized U.S. bank subsidiaries of a financial services holding company.

Supporters of this proposal believed that the "roll-up" requirement assured that domestic banks would not be placed at a competitive disadvantage in their own market. They maintained that the proposal would have assured that the same capital, accounting, regulatory and supervisory requirements (as well as

[11] Neither the Treasury nor the Board believe a subsidiary requirement should be imposed in connection with expanded powers with regard to interstate activities.

[12] The Financial Institutions Safety and Consumer Act of 1991 (FISCCA).

domestic firewalls) would be imposed on foreign and domestic banking organizations that wished to engage in expanded powers. No foreign bank would have been required to "roll-up"; each foreign bank could make a decision based on its own corporate strategy and preference. Foreign banks that did not desire expanded powers in the United States could continue to conduct their banking operations in branches.

Opponents of the 1991 roll-up proposal believed that existing regulatory authority was sufficient to assure that foreign banks seeking to establish operations in the United States would have to meet the same general standards of financial strength, including capital, experience and reputation as required for domestic institutions. The mandatory roll-up of branches of foreign banks seeking expanded powers was considered to be an unnecessary requirement, which would have had undesirable consequences. First, the proposed roll-up requirement would have jeopardized the continued willingness of foreign banks to maintain a U.S. banking presence, thereby potentially removing an important source of credit for U.S. borrowers. Second, the roll-up of branches of foreign banks in this country could have led to similar requirements for U.S. banks abroad. This was not considered to be in the long-term interest of U.S. bank competitiveness, in view of the reliance placed by U.S. banks upon the branch form of organization in their operations abroad.

It is agreed that, under a limited subsidiary requirement, foreign banks that did not wish to take advantage of the expanded powers could have continued to operate in the United States through branches. However, those foreign banks that did wish to engage in the expanded activities would have been denied the advantages associated with branch operations, including access to their worldwide capital, which are discussed in section IV. above.

Since the 1991 financial reform proposals were introduced, adoption of the Foreign Bank Supervision Enhancement Act ("FBSEA") has strengthened the regulators' authority to assure that untoward actions do not jeopardize the safety and soundness of the financial system. In addition, application of the guidelines established in the Report on Capital Equivalency, which reinforced existing regulatory practice, helps assure that U.S. banks will not be placed at a competitive disadvantage in their own market. The findings of the joint annual updates on capital equivalency required by Section 214(b) of FBSEA also provide an opportunity for continuous review of this objective. Finally, FBSEA requires that the Board in consultation with Treasury, establish criteria for banks from countries that do not provide comprehensive supervision on a consolidated basis.

The EC's Second Banking Directive (the "Directive"), which must be implemented by member states by no later than January 1993, has been put forward as one example of treatment of U.S. banks abroad that might serve as a precedent for imposing a

subsidiary requirement on the U.S. banking operations of foreign banks in connection with the availability of new powers. The Directive allows banks incorporated in the Community, including bank subsidiaries of foreign banks, to establish branches or provide services throughout the Community, based upon the authorization and supervision by its home, rather than the host, country.

It has been suggested that the Directive parallels a U.S. subsidiary requirement imposed in connection with the grant of new powers because it requires establishment of a subsidiary to take advantage of the single banking license. Some have complained that the program of liberalization under the Directive does not apply to EC branches of U.S. banks. A brief description of the Directive and the operation and effect of its provisions is provided below.

Under the Directive, a host Member State in general will no longer have a role in the licensing or day-to-day supervision of branches of banks from other Member States and will not be able to limit the number of branches that may be established or to impose endowment capital requirements. The Directive also establishes a list of permissible activities that, if authorized by a bank's home country, may be offered anywhere in the EC even if the host country does not permit its banks to carry on such activities.

The EC's reliance upon home-country rules and home-country administration of those rules in the creation of a single

market is predicated on harmonization among Member States of "essential" national rules pertaining, inter alia, to banking and financial services. In two major respects, this harmonization exercise goes far beyond what the major industrial countries have accomplished through any forum for cooperation, including the Basle Committee on Banking Supervision and the OECD.

First, the harmonizing measures with regard to financial services, which are directed to the creation of a single market, are much broader than the general minimum standards agreed in Basle and encompass other areas besides supervisory standards, e.g., matters relating to corporate law, bank ownership of nonfinancial institutions, initial capital requirements, provisions relating to major shareholders and changes in share ownership, bank and branch accounts, and, in future, deposit insurance and perhaps reorganization and liquidation. Second, the EC harmonizing measures are not just voluntary agreements; instead, they are legally binding as part of the body of Community law, which is supreme over national laws and constitutions.

The Second Banking Directive does not directly address the treatment of branches of banks from the United States and other non-EC countries. Because such branches are not incorporated in an EC Member State, are not subject to the EC's harmonization of essential rules, and do not have an EC Member State as a sponsoring home-country authority, foreign banks operating in a Member State only through branches are not

eligible under the Directive to establish branches or provide services throughout the Community. That is, to receive the full benefits associated with the EC passport, a foreign bank will need to have an EC subsidiary.

The Directive does not prohibit foreign banks from establishing or maintaining both subsidiaries and direct branches. However, foreign bank branches will continue to be subject to approval by the individual EC Member States in accordance with the First Banking Directive.

There are, therefore, similarities and differences between a proposal to impose a subsidiary requirement upon foreign banks' operations in the United States in connection with the grant of new powers and the treatment accorded foreign banks under the Directive. One similarity is that, albeit in very different circumstances and for different reasons, under each program, foreign banks would be required to establish local subsidiaries to avail themselves of different types of market liberalization (namely, the removal of national boundaries in relation to the provision of banking and financial services in the EC[13] and the expansion of permissible activities in United States). Local subsidiaries, of course, do not have access to the worldwide capital of their parents.

The primary difference between the two programs is that, unlike the Administration's 1991 proposal, the EC Second

[13] In contrast, the Administration's 1991 proposal would not have required establishment of a subsidiary to branch on an interstate basis.

Banking Directive does not require that third country banks terminate their EC branch activities in order either to benefit from the passport and liberalization that is provided in the Directive or to establish nonbanking subsidiaries.[14]

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[14] As noted above, each Member State may set its own policies with regard to branches of foreign banks. As discussed further above and in the separate paper regarding Factor 6 - Safety and Soundness, to the extent that individual Member States (such as Germany) impose dotation capital requirements (which require capital to be held in the host country) or other restrictions upon the operations of branches of foreign banks, the benefits of branch operations are significantly reduced.

# INTERNATIONAL NEGOTIATIONS FOR LIBERALIZED TRADE (FACTOR 7)

APPENDIX D

# INTERNATIONAL NEGOTIATIONS FOR LIBERALIZED TRADE (FACTOR 7)

The effect of a subsidiary requirement on international agreements, international negotiations and U.S. bank access to foreign markets is an important factor in analyzing such a requirement. This section specifically addresses the implications a subsidiary requirement would have from two perspectives: 1) international agreements governing financial services issues, including those currently under negotiation or awaiting approval; and 2) bilateral financial market discussions.

Since World War II, the United States has pursued a strategy aimed at achieving open international markets. The view that open markets promote the welfare of all countries has been the driving force behind multilateral and bilateral negotiations to achieve freer trade in goods or services and a more liberal international investment environment.

Over the last fifteen years, negotiations on financial services issues have become an important part of U.S. international economic policy. Treasury Department and other U.S. officials have sought to open financial markets in treaty negotiations, bilateral and multilateral trade agreements, and a variety of other fora.

The goals of the United States in its financial services negotiations have been national treatment and market access for U.S. financial firms. More specifically, the United

States has pursued a policy of national treatment that includes equality of competitive opportunity, the objective of which has been to ensure that other countries' laws and practices do not disadvantage U.S. financial institutions in their ability to compete. In return, the United States has adopted a general policy of national treatment towards foreign financial institutions.

These goals, where achieved, allow U.S. firms to bring their comparative advantage in financial services to foreign markets, thus providing profits and jobs for the U.S. financial services industry and adding to the country's wealth.

This section first examines the legal rules that have been agreed or are being negotiated to govern international banking. The existing legal agreements analyzed are: 1) Friendship Commerce and Navigation Treaties and Bilateral Investment Treaties; 2) the Code of Liberalization of Capital Movements and the Code of Liberalization of Movements of Current and Invisible Transactions negotiated under the auspices of the Organization for Economic Co-operation and Development; and 3) the Canada -- United States Free Trade Agreement.

Proposed future international agreements such as the North American Free Trade Agreement and the Uruguay Round Agreement on Financial Services are also examined, as are bilateral financial policy discussions between the United States and other countries.

## A. International Agreements Governing Financial Services

### 1. Treaties

The United States has negotiated a network of more than fifty bilateral Friendship, Commerce and Navigation Treaties (FCNs) and Bilateral Investment Treaties (BITs) with various trading partners, including France, Germany, Italy, Japan and Korea. These treaties generally impose three obligations in the banking sector:

(1) a country may not impose new limitations on national treatment of existing operations of foreign banks, with national treatment defined as treatment in a particular state that is no less favorable than that provided in that state to banks located in another state;

(2) foreign banks must be granted "the right to maintain branches and agencies to perform functions necessary for essentially international operations in which they are permitted to engage"[1]; and

(3) most-favored-nation (MFN) treatment must be accorded in all respects (e.g., Japanese banks are entitled to no less favorable treatment by U.S. authorities than German banks).

The first of these obligations permits violations of national treatment as long as existing firms are not affected. This obligation would not appear to be violated by a subsidiary requirement imposed on foreign banks because the FCNs and BITs adopt a special definition of national treatment that measures treatment of foreign firms in a particular state with U.S. firms established in <u>other</u> states. Because branching across state lines is generally prohibited in the United States under the McFadden Act, 12 U.S.C. § 36, and the Federal Reserve Act,

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[1] This obligation is contained only in FCN treaties.

12 U.S.C. § 321, national treatment defined in this way would not include the right of a foreign bank to branch under these treaties. Based on this rule, it would appear that a subsidiary requirement imposed on existing or future operations of a foreign bank branch or agency would not be inconsistent with the prohibition against new departures from national treatment.

A subsidiary requirement for all foreign banks in the United States would, however, raise an issue with respect to the second basic banking obligation in the FCNs (this obligation is not present in BITs). This obligation requires that foreign banks be permitted to maintain branches and agencies if a signatory to an FCN permits foreign banks to engage in international banking business in its territory. The term "international banking business" refers to activities such as foreign exchange services, lending services and other banking services incidental to international business, such as that permitted to Edge corporations under the Federal Reserve Act, and limited branches under the International Banking Act. A subsidiary requirement for all foreign banking operations in the United States would appear to be inconsistent with this requirement.

Finally, a subsidiary requirement imposed under a reciprocity statute would be inconsistent with the MFN obligation of the FCNs and BITs. MFN treatment requires the banks of a signatory to an FCN or BIT to be treated no less favorably than any other country's banks. If use of a reciprocity test resulted

in the banks of a signatory to an FCN or BIT being forced to "roll-up," that country would have a claim under its treaty with the United States.

A violation of a treaty would permit the country harmed to proceed in an agreed international forum (e.g., the International Court of Justice) against the offending country or take other actions permissible under international law. Such actions could include retaliation against the firms of the country that took the action inconsistent with the treaty.

### 2. OECD Codes of Liberalization

The Organization for Economic Co-operation and Development (OECD) is an organization of 24 industrialized countries that includes many of the major trading partners of the United States. The members of the OECD have entered into two agreements governing financial services and other business sectors: the Code of Liberalization of Capital Movements (the Capital Code) and the Code of Liberalization of Current Invisible Operations (the Invisible Code). The Capital Code governs direct and portfolio investment in financial services. The Invisible Code deals with, among other things, treatment of established bank branches.

Under the Capital Code, each country is required to permit "investment for the purpose of establishing lasting economic relations . . . by means of . . . creation or extension of a wholly-owned enterprise, subsidiary or branch . . . ." Countries cannot apply conditions "that raise special barriers or

limitations with respect to non-resident (as compared to resident) investors, and that have the intent or the effect of preventing or significantly impeding inward direct investment by non-residents." OECD Capital Code, art. 2(a) & item I.A.

The OECD Members' interpretation of the Capital Code indicates that restrictions on the right to invest in branch form would be inconsistent with the Code. The interpretation has developed in the periodic examinations conducted by the OECD of individual members' markets, and on interpretation by the Secretariat of the OECD. Any definitive legal analysis based on the plain language of the Code would require an analysis of many of the factors identified in the national treatment/competitive equity section of this study to determine whether special barriers are raised to foreign investment through a subsidiary requirement.

A subsidiary requirement would also appear to be inconsistent with the Invisible Code, which requires "equivalent" treatment of bank branches. Section 214 of the Federal Deposit Insurance Corporation Improvement Act of 1991 requires all new insured deposit-taking activities of foreign banks to occur through subsidiaries, and not also direct branches as was previously the case. The United States lodged a reservation to the Invisible Code to account for this restriction. Normally reservations are limited to existing non-conforming measures, but the Invisible Code was in the process of amendment at the time FDICIA was passed and the United States was permitted to take a

reservation. The time for lodging new reservations is now closed; therefore, further restrictions on foreign bank branches may be inconsistent with the Invisible Code.

The formal sanction procedure for violations of the Codes would be referral to the OECD Council -- the political level decision-making body of the OECD -- for consideration of appropriate action. The OECD Council works by consensus; consequently, it is unlikely sanctions would be authorized. Indeed, various OECD members have taken action in the past that is inconsistent with the OECD Codes with no sanctions or retaliation having been sought. For example, when the EC adopted its Second Banking Directive, the reciprocity test contained in Article VII of the Directive was inconsistent with the commitment of OECD members not to adopt any new reciprocity statutes in their financial laws. Nevertheless, a subsidiary requirement that is inconsistent with Code obligations would undermine the integrity of the agreements and damage possibilities for further liberalization under the Codes.

### 3. The Canadian Free Trade Agreement and the North American Free Trade Agreement

In 1989, the Canada -- United States Free Trade Agreement (the CFTA) entered into force. The CFTA contained a number of specific commitments on treatment of Canadian bank subsidiaries in the United States, but only one regarding Canadian bank branches. No other protection was afforded

Canadian bank branches in the FTA because Canada refused to provide U.S. banks the right to branch into Canada at all.

The one obligation applicable to foreign bank branches -- Article 1702(2) -- concerned certain interstate branches of Canadian banks permitted to operate under section 5 of the International Banking Act of 1978 (IBA). Before the IBA was passed, foreign banks were permitted to establish full-service branches in more than one state as long as individual states permitted such branches. In other words, interstate branching restrictions did not apply to direct branches of foreign banks.

After 1978, the interstate branching prohibitions were applied to all foreign banks. In order to protect acquired rights, however, the established branches of foreign banks were "grandfathered." The CFTA guaranteed these grandfather rights for Canadian banks permanently under Article 1702(2). Thus, a subsidiary requirement imposed on the interstate branch offices of Canadian banks which existed at the time of the CFTA could violate the grandfathering provisions of that agreement.

It should be noted that legal sanctions are not specifically authorized under the CFTA for a breach of the financial services obligations. However, the recently negotiated Financial Services Chapter of the North American Free Trade Agreement will incorporate the specific grandfathering provision of the CFTA. When this Agreement enters into force, it will provide a dispute settlement mechanism for breaches of the grandfathering commitment.

In June 1991, the United States began formal negotiations with Canada and Mexico on a North American Free Trade Agreement (NAFTA). The NAFTA provided an opportunity to expand upon the legal commitments made in the CFTA. A major negotiating objective of the United States in the NAFTA negotiations was obtaining the right to branch into Canada and Mexico. This objective was not achieved partly due to the Canadian and Mexican perception of a lack of equivalent market access in the U.S. financial services market. As a result, the NAFTA provides each country the right to require incorporation of financial institutions under its laws, that is, the right to require operation through a subsidiary.

At present, Canada prohibits direct branches of foreign banks into its territory and is permitted to continue to do so under the terms of the NAFTA. Mexico presently permits Citibank to operate in branch form, but has not authorized any other foreign bank to enter Mexico in this form. Mexico has indicated it will permit U.S. banks to enter only in subsidiary form under the liberalization negotiated under the NAFTA.

The Parties to the NAFTA have also agreed, however, that when the United States permits interstate bank branching in its market, the NAFTA Parties will negotiate with a view toward permitting NAFTA-wide branching by NAFTA banks. The imposition of a subsidiary requirement in the United States prior to such negotiations would have a negative impact on such future

negotiations and almost certainly result in Mexico and Canada refusing to allow direct branching in the future.

### 4. Uruguay Round ("UR") Services Agreement

A requirement that all foreign banks conduct banking operations in the United States through subsidiaries could require reservations to the market access commitments of the United States under the Services Agreement and would be inconsistent with U.S. objectives in the Uruguay Round.

#### a. U.S. Objectives in the Round

A major objective of the United States in the UR has been to obtain commitments that insure U.S. banks can establish and operate effectively in foreign countries. As part of this effort, U.S. officials have sought guarantees that U.S. banks will have the option of entering and operating either as branches or subsidiaries. This objective has already been hampered by recent U.S. legislation requiring that new insured deposit-taking operations take place through subsidiaries.

Enactment of a subsidiary requirement with wider effect would further erode, if not eliminate entirely, the ability of U.S. negotiators to support U.S. banks in their desire to operate as branches abroad. United States negotiators would not be able to argue credibly that other countries should commit to allow entry in branch form if the United States did not.

The use or threat of a subsidiary requirement might be argued to enhance U.S. leverage in financial services talks by being "traded off" to obtain commitments to remove similar

measures in other countries. Such a strategy, however, would risk causing the major trading partners of the United States to propose subsidiary requirements or take other adverse actions against U.S. banks abroad in the context of the negotiation. In this regard, the members of the European Community and most other developed countries already permit foreign banks to operate as branches in their territory. As of October 1992, they were prepared to legally guarantee continuation of this practice in the UR.

As noted above, the United States has been seeking in the UR negotiations the elimination of existing prohibitions on branch banking. The extent to which this effort will be successful is unclear. On a more fundamental plane, it is also unclear whether the Round negotiations will produce sufficient liberalization in the financial services area to enable a U.S. commitment to legally guarantee continuation of the present liberal treatment of financial institutions from countries which refuse to liberalize.

The United States has indicated, that if adequate commitments by other countries in the financial services sector were not forthcoming, the United States would be unable to agree to most-favored-nation (MFN) treatment in this sector. Such an MFN exemption would enable the U.S. to exercise selective leverage to achieve liberalization in future bilateral or multilateral negotiations. Such leverage could include a

subsidiary requirement where U.S. banks do not receive reciprocal treatment.

### b. Provisions of the Agreement

Article XVI ("Market Access") of the Services Agreement provides that any Party undertaking commitments in service sectors shall not maintain restrictions on the specific types of legal entities or joint ventures through which a service supplier provides a service, unless such restrictions are reserved. Where no restrictions are inscribed in a Party's schedule of commitments, a Party would be obligated to permit a foreign bank, which otherwise met its prudential requirements, to create or maintain a commercial presence as a branch.

Countries can choose to undertake commitments in financial services with reference to the "Understanding on Commitments in Financial Services" (the "Understanding"). This document is composed of a series of commitments that form an integral part of the draft Services Agreement, although the relationship to Article XVI remains to be determined. (In many areas, the Understanding provides greater or more detailed obligations.) With respect to the "commercial presence" aspect of its market access provisions, the Understanding provides that each Party shall grant financial service providers the right to establish or expand a commercial presence, including branches. In its most recent proposed offer, the United States scheduled its commitments to market access with respect to the

Understanding's market access provisions rather than those of Article XVI.

Under either Article XVI or the Understanding, the U.S. would have certain obligations, subject to reservations, to permit other Parties to operate through branches. Measures may be reserved under both Article XVI and the Understanding, although the latter permits reservations only of existing non-conforming measures. As a practical matter, reservations taken by a country entail a cost, in the form of other countries either taking reservations or refusing to remove restrictions which the U.S. has sought.

**B. Bilateral Financial Market Negotiations**

Bilateral financial services negotiations have been conducted by the United States for several years with Japan, Korea and Taiwan. The issue of subsidiaries versus branches has not arisen in these negotiations, since in all cases U.S. banks are able to establish in their preferred form as branches. However, other kinds of restrictions on U.S. banks do exist in these markets, including the inability to establish as subsidiaries in two countries and restrictions on the type and scope of operations in all three.

The impact on these negotiations of imposition by the U.S. of a subsidiary requirement on the banks of these countries is an open question. It could be that the possibility of doing so on a selective basis would serve as a lever in obtaining concessions on behalf of U.S. banks. Since currently the banks

of these countries enjoy greater access in most respects in the United States than U.S. banks enjoy in the respective countries, the potential imposition of a U.S. subsidiary requirement might provide an element of leverage in the negotiations. However, it is likely that the imposition of an across-the-board subsidiary requirement for all foreign banks would be met with greater reluctance to liberalize or even with retaliatory restrictions.

### C. Summary

A subsidiary requirement imposed on all foreign banks would raise legal issues under the OECD Codes for all branches, and the CFTA with respect to operations of the Canadian IBA-grandfathered interstate branches that existed in 1987. In addition, a subsidiary requirement would appear to be inconsistent with the OECD Codes and the FCNS where imposed on all operations of foreign banks in the United States.

Under the NAFTA a subsidiary requirement would be permissible but would significantly reduce the possibility that U.S. banks could achieve branching rights into Mexico and Canada at a future date despite the further arrangement for future liberalization in the NAFTA with respect to branching.

Under the Uruguay Round a subsidiary requirement could necessitate reservations by the United States and would likely adversely affect negotiations with developed countries to guarantee branching rights of U.S. banks abroad that already exist. A subsidiary requirement would only be useful as a

selective measure to deal with countries that did not make sufficient commitments in the Round.

In other bilateral negotiations, the effect of a subsidiary requirement appears to be an open question. While such a requirement could tend to discourage further efforts to liberalize in these markets, it is also possible that the selective imposition of a subsidiary requirement might serve as leverage for further liberalization.

# APPENDIX E

# OTHER IMPORTANT IMPLICATIONS

# THE NEED TO PROHIBIT MONEY LAUNDERING AND ILLEGAL PAYMENTS (FACTOR 5)

**APPENDIX E**

# THE NEED TO PROHIBIT MONEY LAUNDERING AND ILLEGAL PAYMENTS (FACTOR 5)

## I. SUMMARY AND CONCLUSIONS

All foreign banks doing business in the United States, regardless of form, are subject to the Bank Secrecy Act ("BSA").[1] The ability of regulatory and law enforcement officials to assess and ensure compliance with the BSA and to detect and prosecute money laundering is not affected materially by the form in which a foreign bank has chosen to do business in the United States.

## II. ANALYSIS

Money laundering is defined as "the process whereby one conceals the existence, illegal source, or illegal application of income, and then disguises that income to make it appear legitimate."[2] Activities that would generate such income include drug trafficking, the criminal attempt to avoid paying taxes or a combination of both. Money laundering may be accomplished

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[1] The two titles of Pub. L. 91-508, 84 Stat. 1114 (Oct. 26, 1970), are commonly known as the Bank Secrecy Act. Title I, the Currency and Foreign Transactions Reporting Act, as amended, has been codified at 31 U.S.C. §§5311-26. Title II is codified at 12 U.S.C. §§1829b and 1951-59. The BSA sets forth the currency reporting and recordkeeping requirements for banks and other financial institutions. It has evolved into the major anti-money laundering legislation aimed at the activities of banks.

[2] President's Commission on Organized Crime, Interim Report to the President and the Attorney General, The Cash Connection: Organized Crime, Financial Institutions, and Money Laundering 7 (1984).

through financial institutions using transactions that are no different from transactions normally associated with legitimate commercial or personal financial activities. Whether money laundering occurs through the U.S. branch of a foreign bank or through a subsidiary bank incorporated in the United States, the techniques are the same. These techniques can be very simple, such as exchanging cash for a cashier's check, or very complex, such as schemes involving one or more shell corporations, accounts in offshore banking centers and multiple wire transfers.

The BSA was enacted in 1970 and subsequently amended in an attempt to prevent financial institutions from being used in the money laundering process. The BSA requires all domestic financial institutions, including U.S. offices of foreign banks,[3] to maintain records of transactions and accounts of their customers and to report to the government certain types of transactions that are of particular interest to regulatory and law enforcement agencies. The BSA covers four major areas of financial activity requiring reporting or recordkeeping:

- maintenance of records concerning customers and transactions, including retention of signature cards and checks, and maintenance of ledgers and transaction records;

[3] 12 U.S.C. §§1829b, 1953; 31 U.S.C. §§5313, 5316, 5318(a)(2).

- reporting of all currency transactions involving cash in amounts exceeding $10,000 (or deliberately structured in smaller dollar amounts to evade the $10,000 threshold) (on a form known as a "CTR");
- reporting by any person who transports or causes another to transport monetary instruments (defined as cash or bearer negotiable instruments) exceeding $10,000 or who receives such instruments in the same amount in the United States from abroad (on a form known as a "CMIR"); and
- annual reporting by a person over whom the United States has jurisdiction of any interests in foreign accounts valued in excess of $10,000 (on a form known as an "FBAR").

The BSA currently does not require reporting with respect to funds transfers and there are no plans to impose such requirements.[4]

BSA enforcement resides in the first instance with the Secretary of the Treasury. The Secretary has delegated authority

[4] A funds transfer involves the movement of debits or credits from one financial institution to another. Funds transfers may be made between domestic banks, including U.S. branches of foreign banks, by means of clearing houses established by banks within one locale, by Fedwire (the funds transfer system operated by the Federal Reserve System), or by transfers among correspondent banks by Fedwire or other means such as internal bank communications systems. International funds transfers generally are communicated through SWIFT (Society of Worldwide Interbank Financial Telecommunication, a Belgian based association of banks that provides the communication network for a large number of international funds transfers) and are settled in the United States through CHIPS (Clearing House Interbank Payments System, the funds settlement system operated by the New York Clearing House) and the Federal Reserve System or by book entries.

to monitor BSA compliance by banks to the federal banking agencies. Both civil and criminal penalties may be imposed for violations of the BSA. In addition, each of the federal banking agencies may take administrative action against banks under its supervision for failure to put into place adequate policies and procedures designed to insure BSA compliance.

The issues raised in the Report to the Senate Committee on Foreign Relations from Senators Kerry and Brown, dated September 30, 1992, regarding a subsidiary requirement were considered at length during the course of this study. Each of the three federal banking agencies responsible for supervision of foreign bank offices in the United States ensures that the domestic operations of such offices for which it is responsible (state licensed branches and agencies of foreign banks[5] in the case of the Federal Reserve, federally licensed branches and agencies of foreign banks in the case of the OCC, and insured branches (whether state or federally licensed) in the case of the FDIC) are examined for BSA compliance. This BSA compliance review is equivalent in relevant respects to the compliance review performed in the case of domestic institutions. Where the initial review reveals irregularities, additional verification procedures are employed.[6]

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[5] The large majority of foreign bank branches (80%) and agencies (99%) are state licensed.

[6] In recent years there has been a great deal of harmonization in international standards related to money laundering. Examples include recommendations made by the (continued...)

Heretofore, because it was not the licensing agency for the foreign bank offices it regulates, the Federal Reserve could not revoke the authority of state licensed offices to operate in the event it became aware of violations of the BSA or other federal laws. The Federal Reserve now has that authority where it can demonstrate that there is "reasonable cause" to believe that a foreign bank has committed a violation of law, including a violation of the BSA or the substantive criminal money laundering statute.[7] The Federal Reserve received this new authority at its request in the Federal Deposit Insurance Corporation Improvements Act ("FDICIA").[8] This authority has been implemented in recent revisions to Regulation K.[9] FDICIA also gives the Board the authority to recommend to the OCC that it terminate the license of a federal branch or agency for violations of law. The OCC has independent authority to terminate the license of a foreign bank office it supervises for violations of law.

The federal bank regulatory agencies may impose the same range of penalties administratively (e.g., termination of the license, cease and desist orders and civil money penalties)

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[6](...continued)
Financial Action Task Force headquartered at the OECD, the model regulations published by the Organization of American States and the EC directive on money laundering. This harmonization means that foreign banks operating in the U.S. market are likely to be subject to money laundering restrictions in their home markets.

[7] Money Laundering Control Act of 1986, as amended, 18 U.S.C. §§1956-1957.

[8] P.L. No. 102-242 (Dec. 19, 1991.)

[9] 12 C.F.R. §211.26 (1992).

for violations of law and regulations on a branch of a foreign bank and its personnel that these agencies may impose on a financial institution incorporated in the United States and its personnel. The agencies also may file civil and/or criminal referrals when they have uncovered significant violations. The civil and criminal penalties that may be imposed by federal courts for violations of specific money laundering statutes (which include both fines and imprisonment) apply equally to branches of foreign banks, on the one hand, and banks incorporated in the United States, on the other.

# TAX LIABILITY OF FOREIGN BANKS (FACTOR 8)

APPENDIX E

# TAX LIABILITY OF FOREIGN BANKS (FACTOR 8)

## I. SUMMARY AND CONCLUSIONS

### A. Taxation of U.S. Branches and Subsidiaries

In general, a U.S. subsidiary of a foreign corporation is taxed in the same manner (i.e., on a net basis with respect to all income, wherever earned) and at the same rate as any other U.S. corporation. Interest and dividends paid by the subsidiary to the foreign parent are subject to gross basis tax at a 30 percent rate (or lower treaty rate).

A U.S. branch of a foreign corporation, however, is subject to U.S. tax only with respect to income that is "effectively connected" with a U.S. trade or business conducted by the branch. Effectively connected income of a U.S. branch is subject to tax on a net basis under rules that generally parallel those applicable to U.S. corporations. The applicable tax rate is the regular U.S. corporate rate. The "dividend equivalent amount" is subject to a branch profits tax, and interest allocable to effectively connected income is treated as paid by a U.S. corporation and, therefore, is subject to gross basis tax at a 30 percent rate (or lower treaty rate). These taxes are intended to substitute for the withholding taxes imposed on dividends and interest paid by a U.S. subsidiary to its foreign parent.

Income derived by a foreign corporation from U.S. sources that is not effectively connected with a U.S. trade or business is generally subject to U.S. withholding tax imposed on the gross amount of such income. The statutory withholding rate is 30 percent, but this rate is often reduced under U.S. income tax treaties. Income derived by a foreign corporation from foreign sources that is not effectively connected with a U.S. trade or business is not subject to U.S. tax.

### B. Effects of a Subsidiary Requirement

The effect of a subsidiary requirement on the tax liability of a foreign bank would vary for banks from different countries, due to (1) differences in home country tax laws, (2) the existence of U.S. income tax treaties with some, but not all, home countries and (3) differences between the provisions of existing U.S. income tax treaties with different countries. As an initial matter, therefore, it is not possible to draw a general conclusion as to the overall effect of a subsidiary requirement on the tax liability of foreign banks as a group. Some preliminary conclusions can be drawn, however, as to whether particular tax-related consequences of a subsidiary requirement would tend to have a neutral or non-neutral effect on a foreign bank's tax liability and whether this effect would depend upon tax treaties or home country law.

#### 1. Conversion from Branch to Subsidiary Form

The conversion of a U.S. branch of a foreign bank to a U.S. subsidiary would generally be a tax-free transaction under

the Internal Revenue Code (the "Code"), but the home country tax consequences of the conversion would vary among countries. In addition, the Code would not permit a new U.S. subsidiary to utilize net operating losses (if any) accumulated by a former U.S. branch.

**2. Post-Conversion Operations**

The Code generally seeks to equalize the tax treatment of U.S. branches and U.S. subsidiaries of foreign corporations in order not to create incentives for foreign businesses to choose one form of U.S. operation over the other. This theme of branch-subsidiary equivalence is evident in the rules governing determination of the U.S. taxable income of branches and subsidiaries of foreign corporations, the information reporting requirements that apply to each, and the treatment of home office lending to U.S. operations. A subsidiary requirement would tend to have a neutral effect in these areas.

In some cases, however, application of the Code provisions governing branch and subsidiary operations is affected significantly by U.S. income tax treaties. For example, the effect of a subsidiary requirement on the taxation of repatriated profits would depend on the existence of an applicable U.S. income tax treaty and on whether the provisions of that treaty currently permit imposition of the branch profits tax.

Similarly, the effect of a subsidiary requirement on the tax cost of lending to U.S. customers would vary, depending upon the existence of an applicable U.S. income tax treaty and

the withholding rate provided in that treaty with respect to interest payments. It is conceivable that the capital requirements that would apply to a new U.S. subsidiary would cause a foreign bank to prefer to make large U.S. loans from its home office, rather than from the subsidiary. Interest paid on home office loans would be subject, however, to gross basis U.S. withholding tax. Although many U.S. income tax treaties would eliminate this withholding tax, there are significant cases in which either no U.S. income tax treaty exists or the applicable treaty retains a positive withholding rate for interest. In these cases, the U.S. withholding tax on interest could eliminate a foreign bank's net profit on a U.S. loan made from the home office. The combined effect, therefore, of increased capital requirements for loans made by a U.S. subsidiary and withholding tax on interest paid on home office loans (where applicable) could be a reduction in lending to U.S. customers by foreign banks based in affected countries.

## II. ANALYSIS

### A. Tax Consequences of Conversion from Branch to Subsidiary

#### 1. Conversion Transaction

Under Code section 351, a foreign bank's transfer of U.S. branch assets to a new U.S. subsidiary in exchange for stock of the new subsidiary would generally be a tax-free

nonrecognition transaction.[1] A foreign bank's home country, however, could impose a tax on built-in gain inherent in appreciated assets of a U.S. branch when those assets were transferred to a U.S. corporation.[2] In this case, the foreign bank could incur a home country tax liability upon conversion of its U.S. branch to a U.S. subsidiary, notwithstanding the tax-free nature of the transaction under U.S. law.[3]

### 2. Post-Conversion Use of Branch Net Operating Losses

A U.S. branch of a foreign corporation is permitted to use U.S. net operating losses generated in one taxable year to reduce its U.S. taxable income in a prior or subsequent year. Under Code section 172, net operating losses may be carried back three years or forward fifteen years. This carryover rule

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[1] If the foreign bank receives property other than stock of the new subsidiary (e.g., debt securities), gain recognition will be required. In addition, the tax consequences of the conversion transaction could differ if the U.S. branch assets are held through a special purpose foreign subsidiary of the foreign bank and that foreign subsidiary is converted into a U.S. corporation by means of a reorganization described in Code section 368(a)(1).

[2] Code section 367(a) imposes such a tax on the transfer of certain types of appreciated assets from a U.S. corporation to a foreign corporation.

[3] The incorporation of a U.S. branch would not trigger the branch profits tax (discussed below) if, under Treas. Reg. §1.884-2T(d), the U.S. branch elected to transfer its accumulated earnings and profits to the new U.S. subsidiary. In addition, the foreign parent corporation would have to agree to recognize gain (subject to certain limitations) upon a subsequent transfer of the stock of the new U.S. subsidiary. The transferred earnings and profits would then be taxed upon subsequent distribution (as a dividend) to the foreign parent corporation. If an election to transfer the accumulated earnings and profits were not made, the accumulated earnings and profits would be subject to taxation upon termination of the branch.

reduces the disparity between the taxation of businesses that have stable income and the taxation of businesses that experience income fluctuations. Code section 172 generally requires, however, that net operating losses be used by the same legal entity that incurred the losses.[4] Thus a foreign bank required to convert its U.S. branch to a U.S. subsidiary would generally lose the ability to carry its branch net operating losses forward into future years. The effect of this rule on any particular foreign bank would depend upon whether its U.S. branch had accumulated net operating losses prior to conversion and, if so, the extent of those losses.

### B. Subsidiary Operations: Areas Where Tax Treaties Have Minimal Effect

As noted above, the Code generally seeks to achieve equivalent tax treatment of the operations of U.S. branches and U.S. subsidiaries of foreign corporations in order to avoid the creation of incentives for operation in one form or the other. The effect of a conversion of a U.S. branch to a U.S. subsidiary would thus tend to have a relatively neutral effect on a foreign bank's U.S. operations in situations where the application of relevant Code provisions is not significantly affected by U.S. tax treaties.

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[4] Although Code section 381 permits transfer of net operating losses to a different legal entity in some circumstances, these exceptions would not generally apply to a conversion of a U.S. branch to a U.S. subsidiary.

### 1. Determination of Taxable Income

Assuming that there is no significant change in the U.S. business of a foreign bank when it converts from branch to subsidiary form, there should not be a significant change in the amount of its U.S. taxable income.

#### a. U.S. Branch

Under Code section 882, the U.S. branch of a foreign corporation is subject to net basis taxation with respect to income that is "effectively connected" with its U.S. trade or business ("ECI"). ECI is taxed at the same rate that applies to a U.S. corporation and may be subject to the alternative minimum tax imposed by Code section 55. A foreign corporation may not include a U.S. branch in a consolidated federal income tax return filed for any U.S. subsidiaries.

Interest income from a banking, financing or similar business activity is treated as ECI if the loans on which the interest is received are attributable to the U.S. branch. Under Treas. Reg. §1.864-4(c)(5)(iii), a loan is treated as attributable to a U.S. branch if that branch "actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the acquisition of" the loan.[5] Similar rules apply with respect to income from

[5] The fact that a foreign bank books a loan made to a U.S. customer in a foreign office (e.g., an office located in a low-tax jurisdiction) is not determinative as to whether interest income associated with that loan is taxable in the U.S. as ECI of a U.S. branch. If personnel employed in a U.S. branch of a foreign bank (continued...)

securities held in connection with a banking, financing or similar business. Income from services is generally considered ECI if the services were performed in the U.S. Transactions between a U.S. branch and its home office (or other non-U.S. branches of the same foreign corporation) are generally disregarded for purposes of determining ECI.

In computing taxable ECI, foreign corporations are allowed the same deductions allowed to U.S. corporations, to the extent that those deductions are connected with ECI. The most significant deduction allowable to a U.S. branch of a foreign bank is the interest deduction, determined under Treas. Reg. §1.882-5. The underlying objective of Treas. Reg. §1.882-5 is to determine the approximate amount of interest expense that would have been deductible by a U.S. branch if the branch were a subsidiary. The regulation permits a U.S. branch to deduct interest expense associated with its "U.S.-connected liabilities." To compute the amount of U.S.-connected liabilities, the regulation assumes that the liability-to-asset ratio of the U.S. branch is the same as that of the foreign bank as a whole. This ratio is multiplied by the value of the assets held by the U.S. branch to determine the amount of U.S.-connected liabilities. If the amount of U.S.-connected liabilities does not exceed the amount of liabilities actually booked in the U.S.

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[5](...continued)
actively and materially participated in activities associated with the making of a loan booked outside the U.S., interest income derived from the loan will be treated as taxable ECI of the U.S. branch.

branch, the interest deduction is computed by multiplying the amount of U.S.-connected liabilities by the average interest rate paid by the U.S. branch for the year. If the amount of U.S.-connected liabilities does exceed the amount of liabilities actually booked in the U.S. branch, the foreign bank's home office is treated as having borrowed the excess amount on behalf of the U.S. branch and reloaned it to the U.S. branch. The interest deduction of the U.S. branch in this case is the sum of (1) the amount of booked liabilities multiplied by the average branch interest rate for the year and (2) the amount of the excess U.S.-connected liabilities multiplied by a worldwide dollar interest rate.

**b. U.S. Subsidiary**

A U.S. subsidiary of a foreign corporation is taxed in the same manner as a U.S.-owned corporation. Thus a U.S. subsidiary of a foreign bank would be subject to net basis taxation on its worldwide income at a maximum rate of 34 percent and could be subject to the alternative minimum tax. A U.S. subsidiary owned by a U.S. holding company would be eligible to file a consolidated federal income tax return with the holding company.

Income reported by a U.S. subsidiary with respect to transactions with its foreign parent corporation or any other related person may be subject to adjustment under Code section 482 where necessary to clearly reflect the income of the U.S. subsidiary. Code section 482 and the regulations thereunder

generally apply an arms' length standard for review of related person transactions.

Assuming that the business of a new U.S. subsidiary were essentially the same as the business conducted by a former U.S. branch, the worldwide income of the subsidiary should roughly correspond to the ECI of the former U.S. branch. In addition, the amount of the interest deduction allowed to a new U.S. subsidiary should be roughly comparable to the amount of the interest deduction allowed to the former U.S. branch. As noted above, the general objective of Treas. Reg. §1.882-5 is to compute an interest deduction for a U.S. branch that is comparable to the interest deduction which would have been allowed if the branch were a U.S. subsidiary.

**2. Information Reporting and Record Maintenance**

The U.S. tax information reporting and record maintenance requirements that apply to U.S. branches and U.S. subsidiaries of foreign corporations are designed to be comparable. Differences that do exist are generally limited to those necessitated by the difference in the form of the entity. Thus a foreign bank should not experience a substantial change in its information reporting and record maintenance requirements upon conversion of a U.S. branch to a subsidiary.

**a. U.S. Subsidiary: Code section 6038A**

Under Code section 6038A and the Treasury regulations thereunder, a foreign-controlled U.S. corporation engaged in a U.S. business must file an information return (on IRS Form 5472)

describing "reportable transactions"[6] with related persons (including a parent corporation, brother-sister corporations, and U.S. or foreign subsidiaries) and must maintain certain records relevant to these transactions in the United States. Substantial monetary penalties apply in the event of a failure to satisfy these requirements.

A foreign-controlled U.S. corporation to which Code section 6038A applies is a U.S. corporation that is 25 percent foreign-owned, i.e., 25 percent or more of the total voting power or value of its stock is owned by at least one foreign person at any time during the taxable year. A separate IRS Form 5472 must be filed by the foreign-controlled U.S. corporation with respect to each related party with which the foreign-controlled U.S. corporation had a reportable transaction. The aggregate dollar amount for all reportable transactions must be provided on each Form 5472, as well as the separate dollar amount for each category of reportable transactions.

A foreign-controlled U.S. corporation must maintain records (or cause another person to maintain records) sufficient to establish the correctness of the corporation's federal income

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[6] Reportable transactions include sales and purchases of inventory; sales and purchases of other tangible personal property; sales, purchases, and amounts paid and received as consideration for the use of intangible property; other rents and royalties received; consideration paid and received for technical, managerial, engineering, construction, scientific or similar services; commissions paid and received; amounts loaned and borrowed (other than trade receivables paid or collected in full in the ordinary course of business); interest paid or received; and premiums paid and received for insurance or reinsurance.

tax return and the correct treatment of all reportable transactions with related persons. Records must be maintained in the United States, unless a special election is made under which the foreign-controlled U.S. corporation agrees to produce foreign-held records for the IRS. Under a "safe harbor" rule, reporting corporations that maintain records in certain specified categories are deemed to satisfy the record maintenance requirement. Any foreign person related to a foreign-controlled U.S. corporation must authorize the foreign-controlled U.S. corporation to act as its agent for purposes of IRS examination of its books and records and for the service and enforcement of a summons relating to any reportable transaction with the foreign-controlled U.S. corporation.[7]

**b. U.S. Branch: Code section 6038C**

Code section 6038C requires that a foreign corporation engaged in a U.S. trade or business file an information return (on IRS Form 5472) that identifies all foreign shareholders owning 25 percent or more of their stock and describes reportable transactions between the foreign corporation and related persons (including its significant foreign shareholders). Substantial monetary penalties apply in the event of a failure to file the requisite information return or to maintain adequate supportive records.

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[7] Foreign-controlled U.S. corporations with less than $10,000,000 in gross receipts are exmept from this requirement, as well as the record maintenance requirements discussed above.

Although Treasury regulations have not yet been issued under section 6038C, that section incorporates by cross-reference the information reporting and record maintenance requirements of Code section 6038A (applicable to foreign-controlled U.S. corporations). It is thus expected that the transactions identified as "reportable" in forthcoming Treasury regulations under section 6038C will be comparable to those identified in the existing Treasury regulations under section 6038A, and that the record maintenance requirements imposed by the section 6038C regulations will be similar to those of the section 6038A regulations. In addition, the House Ways and Means Committee Report on the Revenue Reconciliation Act of 1990 indicates that a foreign corporation may be required to provide information and maintain records relevant to the allocation and apportionment of deductible expenses (including deductible interest expense) to effectively connected U.S. branch income and the allocation of income and deduction amounts between the U.S. and foreign countries. See House Ways and Means Comm. Rpt. on H.R. 5835 at p. 72-3.

### 3. Home Office Lending to U.S. Operations

Under Code section 884(f), interest deemed paid by a U.S. branch to a foreign home office is subject to an excess interest tax designed to correspond to the withholding tax that applies to interest payments by a U.S. corporation to a foreign lender. Interest expense that is deductible under Treas. Reg. §1.882-5 (discussed above) is treated as "excess interest" to the

extent that it exceeds the interest expense actually paid by the U.S. branch. The amount of "excess interest" effectively equals the amount of interest expense associated with the excess of U.S.-connected liabilities over booked liabilities (as determined under Treas. Reg. §1.882-5). As noted above, this excess amount of liabilities is treated as having been incurred by the foreign corporation's home office on behalf of the U.S. branch and re-loaned to the branch. The rate of the excess interest tax is 30 percent, the same as the statutory withholding rate for interest payments. For corporations which are "qualified residents" of a treaty country, the excess interest tax is imposed at the reduced treaty rate provided for interest withholding. The conversion of a U.S. branch to a U.S. subsidiary should thus tend to have a relatively neutral effect on inter-office lending practices of a foreign bank.

### C. Subsidiary Operations: Areas Where Tax Treaties Have Significant Effect

Although the Code generally seeks to achieve equivalent tax treatment of the operations of U.S. branches and U.S. subsidiaries of foreign corporations, some Code provisions governing operation in branch or subsidiary form are significantly affected by applicable U.S. income tax treaties. In these areas, a foreign bank's conversion of its U.S. operations from branch to subsidiary form may have a non-neutral effect.

### 1. Repatriation of Profits

A number of U.S. income tax treaties prevent imposition of the branch profits tax (designed to correspond to the dividend withholding tax). For foreign banks from these countries, the withholding tax applicable to dividends paid by a new U.S. subsidiary would represent an additional cost of repatriating U.S. profits.

#### a. U.S. Branch: Branch Profits Tax

No U.S. withholding tax is imposed on profits repatriated from a U.S. branch to the home office of a foreign corporation. Instead, Code section 884 imposes a "branch profits tax" on an amount of profits deemed to have been remitted by a U.S. branch (the "dividend equivalent amount"). The dividend equivalent amount for a taxable year is generally equal to the amount of branch profits for the year, reduced by increases in U.S. investment and increased by reductions in U.S. investment during the year. The branch profits tax is intended to correspond to the shareholder-level withholding tax imposed on dividends paid by a U.S. subsidiary to a foreign parent. The tax is a second-level tax imposed in addition to the regular tax imposed on U.S. branch ECI. The statutory rate of the branch profits tax is 30 percent (the same as the dividend withholding tax rate).

For corporations which are "qualified residents" of a treaty country, the branch profits tax is imposed at the reduced treaty rate provided for withholding on dividends paid to a 100

percent shareholder. The branch profits tax is considered discriminatory, however, under a number of significant U.S. tax treaties and is not imposed on U.S. branches of corporations resident in the affected countries.[8]

**b. U.S. Subsidiary: Dividend Withholding Tax**

Under Code section 881, dividends paid by a U.S. subsidiary to a foreign parent corporation are subject to U.S. withholding tax at a statutory rate of 30 percent. This rate is reduced by U.S. income tax treaties -- often to 5 percent for dividends paid to a direct investor (i.e., a corporate investor owning at least 10 percent of the stock of the dividend-paying corporation).

As noted above, the branch profits tax is designed to correspond to the dividend withholding tax. Thus, in many cases, a foreign bank switching from the branch profits tax to dividend withholding (upon conversion of its U.S. operations to subsidiary form) should not face a substantial change in U.S. tax liability on repatriated profits. For a foreign bank resident in a country whose income tax treaty with the U.S. does not permit imposition of the branch profits tax, however, dividend withholding would

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[8] U.S. income tax treaties that do not permit imposition of the branch profits tax are those with Aruba, Austria, Belgium, China, Cyprus, Denmark, Egypt, Finland, Greece, Hungary, Iceland, Ireland, Italy, Jamaica, Japan, Korea, Luxembourg, Malta, Morocco, Netherlands, Norway, Pakistan, Philippines, Sweden, Switzerland, United Kingdom. Countries whose income tax treaties with the U.S. do permit imposition of the branch profits tax include Australia, Barbados, Canada, France, Germany, India, New Zealand, Poland, Romania, Spain, Trinidad & Tobago, and the countries of the former U.S.S.R.

increase the U.S. tax cost of repatriating profits to the home office. However, it should also be noted that dividend withholding would eliminate a competitive advantage which banks from those countries currently enjoy over banks from countries whose treaties permit imposition of the branch profits tax or from countries with no U.S. tax treaty.

### 2. Interest Paid by U.S. Customers

It is possible that the capital requirements applicable to a U.S. subsidiary of a foreign bank would cause a foreign bank to restrict the lending activities of the U.S. subsidiary (after enactment of a subsidiary requirement). In this situation, the potential application of withholding tax to interest paid by U.S. customers to the foreign bank's home office could (where not eliminated by treaty) preclude a compensating increase in U.S. lending activity by the home office. The result could be an overall restriction in lending to U.S. customers by foreign banks in affected countries.

#### a. Interest Paid to U.S. Branch or U.S. Subsidiary

Interest paid by a U.S. customer to a U.S. branch of a foreign bank is not subject to U.S. withholding tax if the interest income represents ECI of the branch (which is subject to net basis U.S. income taxation). Interest that is not ECI is subject to U.S. withholding tax at a statutory rate of 30 percent or a reduced treaty rate.[9] Interest paid by a U.S. customer to

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[9] As a practical matter, virtually all interest paid by U.S. customers to U.S. branches of foreign banks is ECI.

a U.S. subsidiary of a foreign bank is treated in the same manner as interest paid to any other U.S. person, i.e., it is exempt from U.S. withholding tax.

b. **Interest Paid by U.S. Customer to Home Office**

A foreign bank that made large U.S. loans through a new U.S. subsidiary would be required to maintain substantial capital in the U.S. subsidiary. A foreign bank might thus prefer to make large loans to U.S. customers from its home office, e.g., by participating in a syndication arranged by a U.S. bank. Interest paid by a U.S. customer to the home office of a foreign bank is subject, however, to U.S. withholding tax at a statutory rate of 30 percent.[10] Interest withholding is eliminated under many U.S. tax treaties, but remains at a positive rate under some significant treaties, e.g., Canada (15 percent), Japan (10 percent) and Switzerland (5 percent). In addition, many foreign banks with U.S. operations are based in countries which do not have income tax treaties with the U.S., e.g., Hong Kong, the Middle East and Latin America.

Even at a reduced treaty rate, a gross basis U.S. withholding tax on interest paid by a U.S. customer to a foreign

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[10] Statutory exceptions from U.S. withholding tax include: (a) interest on bank deposits, under Code sections 881(d) and 871(i); (b) portfolio interest, which specifically does not include interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business, under Code section 881(c); and (c) interest on certain short-term discount obligations with a maturity of 183 days or less, under Code section 871(g)(1)(B). None of these exceptions would be useful to a foreign bank making loans to U.S. customers in the ordinary course of its business.

bank's home office could eliminate the small profit margin typical of the lending business. In contrast, interest paid to a U.S. branch is subject to net basis U.S. tax that is usually less than 2 percent of the gross amount of interest received. In addition, a net basis U.S. tax is usually fully creditable against net basis home country tax, whereas a gross basis U.S. withholding tax would usually exceed the net basis home country tax, resulting in excess foreign tax credits. Although the potential for elimination of profit on U.S. loans could encourage foreign banks to make U.S. loans through a new U.S. subsidiary, it seems more likely that the combined effect of the U.S. capital requirements applicable to a U.S. subsidiary and the withholding tax implications of home office lending would be a reduction in lending to U.S. customers by foreign banks not eligible for a treaty exemption from withholding tax.

The imposition of U.S. withholding tax on interest paid to the home offices of banks located in these countries would presumably give these countries a new incentive to agree to a treaty exemption for bank loan interest. The U.S. Model Income Tax Treaty provides an exemption from withholding for interest income. Some countries have historically been unwilling, however, to agree to an exemption for bank loan interest in order to protect their domestic banking industries, i.e., because a withholding exemption would permit U.S. banks to compete with domestic banks for the business of domestic customers. To the extent that treaties could be renegotiated to provide an

exemption for bank loan interest, the potential effect of the withholding tax would be mitigated. If this does not occur, however, the potential for reduced lending to U.S. customers may be the most significant tax-related consequence of a subsidiary requirement for foreign banks.

# DIFFERENCES IN TREATMENT OF UNITED STATES CREDITORS UNDER BANKRUPTCY AND RECEIVERSHIP LAWS (FACTOR 10)

**APPENDIX E**

# DIFFERENCES IN TREATMENT OF UNITED STATES CREDITORS UNDER BANKRUPTCY AND RECEIVERSHIP LAWS (FACTOR 10)

## I. SUMMARY AND CONCLUSIONS

Under U.S. law and procedure, a creditor of an insolvent U.S. branch of a foreign bank would be treated in much the same way as a creditor of an insolvent domestic bank subsidiary of a foreign bank parent. Each creditor would have a U.S. forum -- either a state or federal liquidation proceeding -- in which to pursue its claim. Each would have access, by virtue of that proceeding, to assets of the branch or subsidiary under the jurisdiction of the U.S. liquidator. In addition, however, the branch creditor potentially would have access, in a foreign forum or forums, to the worldwide assets of the foreign bank. The subsidiary creditor would not have any legal claim to such additional assets, assuming no legal or factual basis exists for piercing the corporate veil.

## II. ANALYSIS

### A. Background

Tremendous diversity exists in the ways in which countries deal with insolvent banks. U.S. bank insolvencies are outside the scope of general bankruptcy legislation and instead are treated under state and federal banking laws administered by bank regulatory authorities, while bank insolvencies in many other countries are handled pursuant to general insolvency laws.

Some countries, including the United States, liquidate foreign bank branches as separate entities; others either attempt to liquidate the entire foreign bank or simply collect assets and transfer them to the home country liquidator for disposition in the liquidation proceeding pending there. This diversity has hindered the development of common approaches to multinational insolvencies even among countries actively promoting cooperation on other economic issues.[1] It is unlikely that multinational bank insolvency will be the subject of multilateral treaty or agreement in the near term.

One internationally recognized principle of bankruptcy law is that similarly situated creditors should share equally in the assets of the debtor's estate. In practice, however, local law and policy frequently dictate that equal treatment means all creditors of a local debtor, whether such creditors are themselves local or not, should be treated in accordance with local law. Thus, the principle of equal treatment accommodates two competing theories of bankruptcy administration: universality -- where deference generally is given to the legal proceedings in the country in which the insolvent entity is organized and the worldwide creditors and assets of a debtor are treated in accordance with the laws of that country -- and territoriality -- where no such deference is given and any

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[1] See R. Gitlin & E. Flaschen, "The International Void in the Law of Multinational Bankruptcies," 42 Bus. Law. 307, 311-13 (1987) (discussing history of EC's efforts to negotiate a bankruptcy convention).

country may administer its own bankruptcy proceedings without regard for foreign proceedings or judgments.

### B. Applicable Federal and State Law

State and federal bank insolvency rules, as well as the federal bankruptcy code, generally reflect a territorial approach.[2] The same basic rules currently apply to insolvencies of U.S. branches of foreign banks and to insolvencies of banks organized under the laws of the United States that are owned or controlled by foreign banks or foreign bank holding companies. This parity of treatment is accomplished in the case of branches by treating an insolvent branch as an entity separate and apart from the rest of the foreign bank for purposes of actual liquidation.[3]

#### 1. Branch Liquidation for Insolvency

Under federal law, the Office of the Comptroller of the Currency ("OCC") is authorized to appoint a receiver to liquidate a federal branch of a foreign bank. In the case of an insured branch, the receiver would be the Federal Deposit Insurance

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[2] Section 304 of the federal bankruptcy code, 11 U.S.C. §304, which reflects a more universalist approach, is discussed infra at page 9.

[3] See e.g., 12 U.S.C. §3102(j)(2) (provision of the International Banking Act governing claims that may be made in liquidations of federal branches); N.Y. Banking Law §606-4 (McKinney 1971) (permits N.Y. Superintendent to take possession of all property of a foreign bank in the state in connection with liquidation of a foreign bank office licensed by the state).

Corporation ("FDIC").[4] The OCC may appoint a receiver for certain violations of law; where a conservator has been appointed for the foreign bank in the bank's home country; when the bank does not pay a judgment obtained by a creditor against it, arising out of a transaction with its branch; or if the OCC determines that the foreign bank is insolvent.[5] The receiver has a broad mandate; he or she may take possession of all of the foreign bank's agencies and branches (including state-licensed offices), and any additional property or asset of the foreign bank located in the United States.[6] The applicable law creates a preference for claims of third party depositors and other creditors against a foreign bank arising out of transactions with any branch or agency of the foreign bank in the United States. The receiver is prohibited from paying any claims that would not represent an enforceable legal obligation against the branch if it were a separate legal entity (e.g., a subsidiary).[7] These preferences and prohibitions define the assets of the branch broadly -- to include all of the foreign bank's U.S. assets and not simply the assets of the branch itself -- and the claims against the branch narrowly, thereby benefiting local creditors.

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[4] At present, most branches of foreign banks are not FDIC insured.

[5] 12 U.S.C. §3102(j). The OCC also may appoint a receiver if it determines that an insured branch is critically undercapitalized. 12 U.S.C. §1831o(h)(3).

[6] 12 U.S.C. §3102(j)(1).

[7] 12 U.S.C. §3102(j)(2).

After all valid claims are paid, the receiver is authorized to turn over any excess assets of the branch to the head office of the foreign bank or to a duly appointed local liquidator of such foreign bank.

State-licensed branches of foreign banks are subject, in the first instance, to the liquidation laws of the licensing state. In practice, a state-licensed insured branch would be liquidated by the FDIC. State-licensed branches that are not insured would be wholly subject to state bank liquidation law. The states with a substantial foreign bank presence follow a separate entity approach which is comparable to that followed by the OCC as liquidator of federal branches.[8]

This approach has the advantage of affording U.S. creditors of a branch a U.S. forum, as they would have if the branch had been a subsidiary, but not denying them access, albeit perhaps in other forums, to the bank's worldwide capital and assets. Creditors of a subsidiary, unlike creditors of a branch, generally have no rights to the assets of the corporate parent. Access to worldwide assets was recognized as a crucial factor favoring the branch form in the report of the Superintendent's Advisory Committee on Transnational Banking Institutions recently published by the New York State Banking Department. Of course,

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[8] See e.g., Cal. Fin. Code §§1781, 1785 (West) (foreign bank office to be liquidated in accordance with law applicable to state bank); Fla. Stat. Ch. 663.02 (same); Ill. Rev. Stat. Ch. 17, paras. 2701, 2719, 2725 (1991) (same); N.Y. Banking Law §606-4 (McKinney 1971) (same).

access to worldwide capital and assets has important implications for the other factors addressed in this study.

**2. Subsidiary Liquidation for Insolvency**

A U.S. bank subsidiary of a foreign bank would be liquidated in the same manner as a U.S. bank subsidiary of a U.S. bank holding company. If the U.S. subsidiary were a national bank, the national bank liquidation procedures would apply. If the U.S. subsidiary were a state chartered bank, the liquidation procedures of the chartering state would apply. Generally speaking, the chartering entity would close the institution and the FDIC would act as receiver. The assets available to the receiver would be those of the subsidiary and would not include assets of the parent, assuming no legal or factual basis exists for piercing the corporate veil.

Unlike the case of a branch or agency, where the insolvency of the foreign bank itself would necessarily trigger a liquidation of the branch, the insolvency of a foreign bank parent of a U.S. subsidiary would not necessarily require the liquidation of the U.S. subsidiary.[9] In general, however, when a

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[9] Canadian Commercial Bank ("CCB"), a mid-sized Canadian bank based in Edmonton, Alberta, failed in 1985. CCB was liquidated pursuant to Canadian law by Price Waterhouse, Ltd., a court appointed liquidator. At the time of the failure, CCB had both an indirect state chartered bank subsidiary, Commercial Center Bank ("Commercial Center") in Santa Ana, California, and a state-licensed Los Angeles agency. The agency was closed in September 1985 and liquidated as a separate entity by the California authorities. All permitted claims were paid in full and the excess assets were transferred to the Canada Deposit Insurance Corporation ("CDIC"), the entity that held the assets (continued...)

parent fails an otherwise sound subsidiary also suffers because of the effects on market confidence.[10]

**C. Case Studies**

Recent experience with liquidations of U.S. branches of foreign banks is consistent with these conclusions.[11] There have been very few involuntary liquidations of U.S. branches of foreign banks since 1945. All have involved uninsured state-licensed branches; neither the OCC nor the FDIC has been required to liquidate a branch under its supervision for reasons of

[9](...continued)
of CCB in liquidation. Commercial Center was not closed at the time of the CCB liquidation. The CDIC has continued to support the bank by funding it and putting in place a management team. In the absence of such foreign government support -- which could not be expected to occur in all cases -- U.S. regulators might have been required to liquidate Commercial Center, which could have resulted in losses to either the insurance fund or depositors.

[10] See e.g., Treasury and Civil Service Comm., Fourth Report -- Banking Supervision and BCCI: International and National Regulation, Bank of England Response (July 1992) Annex 2 (I)(a)(11). The problems experienced by the First American banks in the aftermath of the closing of BCCI are consistent with this general trend.

[11] In an effort to obtain comparative data on this issue, the Justice Department surveyed banking requirements in a selected sample of jurisdictions. These jurisdictions were chosen because they were representative of the types of jurisdictions in the U.S. foreign bank community (United Kingdom, Italy, Japan, India, Qatar and Argentina). None of the jurisdictions surveyed require that foreign banks conducting regular banking operations in their territory do so through domestically incorporated subsidiaries. Where banks have the option, as they do in the United States, of conducting operations directly through branches or indirectly through subsidiaries, they generally choose the branch form of organization. Thus, there is an absence of comparative data to support a judgment that the use of one form of bank organization is superior to the other in protecting domestic depositors in the event of insolvency.

insolvency. In these liquidations, the insolvency of the branch was part of the insolvency of the entire institution and contemporaneous liquidation proceedings were underway in the home country. In each case, all valid claims were paid in full.

- In the late 1960s, the New York State Superintendent of Banks liquidated the New York branch of Intra Bank, S.A., a Lebanese bank. The estate was large enough to pay all validated claims. The surplus went to the U.S. government in compromise of a claim of the Commodity Credit Corporation that initially had been rejected by the Superintendent.[12]

- In early 1980, the New York Superintendent liquidated the New York branch of Banco de Intercambio Regional, S.A., an Argentine bank. The estate was large enough to pay all claims of branch creditors. The surplus was turned over to the Argentine liquidator.[13]

- In the ongoing liquidations of the New York and California depository agencies of the Bank of Commerce and Credit International, S.A. ("BCCI"), each of the New York and California Superintendents expects there to be a surplus after the payment of valid claims.

The liquidations of BCCI's New York and California agencies, though not directly relevant to this study because they involved agencies as opposed to branches, are nonetheless instructive as contemporary examples of a complex, multinational bank failure involving simultaneous liquidations of the foreign bank itself in the home country and multiple liquidations of subsidiaries and unincorporated offices around the world. The state liquidations were complicated by the early filing in U.S. bankruptcy court of petitions, under section 304 of the federal

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[12] In Re Willie, 61 Misc. 2d 992, 30 N.Y.S.2d 520, 543 (Sup. Ct. 1968).

[13] In Re Seibert, 135 Misc. 2d 1093, 517 N.Y.S.2d 358 (Sup. Ct. 1987).

bankruptcy code, by the foreign liquidators of BCCI and the pendency of a criminal case which resulted in the forfeiture by BCCI of certain U.S. assets.

The major section 304 proceeding was filed by BCCI liquidators appointed by the courts of Luxembourg, where BCCI was organized, the United Kingdom, where BCCI was headquartered, and Grand Cayman, where BCCI Overseas, a sister company, was organized. The petition and accompanying motion sought a temporary restraining order which, if granted, could have prevented the Superintendents in New York and California from proceeding with the liquidations of the BCCI agencies in those states. Section 304 permits a foreign representative of a foreign debtor to petition to enjoin the commencement or continuation of any proceedings against the debtor with respect to property involved in a foreign proceeding and to order the turnover of the U.S. assets of the debtor for administration by the foreign representative.[14] U.S. bank regulators took the position in court that section 304 should not be used to enjoin or otherwise interfere with a bank insolvency proceeding.[15] The judge did not enjoin the continuation of either the California or the New York liquidation nor did he reach the merits of the regulators' argument that section 304 should not apply to state or federal bank liquidation proceedings. Instead, California and

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[14] 11 U.S.C. §304.

[15] In Re Smouha, Case No. 91-B-13569 (JLG), U.S. Bankr. Ct., S.D.N.Y.

New York negotiated a settlement with the foreign liquidators which permitted the liquidations to go forward unimpeded. The foreign liquidators agreed not to make any claims against BCCI assets until after the state liquidations were concluded.

The BCCI liquidations are not yet complete. Nonetheless, a few important conclusions can be drawn from them. First, in spite of the complications created by the section 304 proceeding, the state-appointed liquidators in both New York and California have been able to conduct their liquidations in accordance with the rules and principles outlined above. Second, the liquidators have at least as many assets under their jurisdiction that they would have had if the agencies had been separately incorporated subsidiary banks of BCCI. Finally, the outcome of the BCCI liquidations in all likelihood will be consistent with prior cases; that is, the liquidator will be left with excess assets after all valid claims of the agencies' creditors are paid.

# REPORT OF THE SUPERINTENDENT'S ADVISORY COMMITTEE ON TRANSNATIONAL BANKING INSTITUTIONS

MARIO M. CUOMO
GOVERNOR

DERRICK D. CEPHAS
SUPERINTENDENT OF BANKS

JOHN G. HEIMANN
CHAIRMAN

MARCH, 1992

# REPORT

# OF THE

# SUPERINTENDENT'S ADVISORY COMMITTEE

# ON

# TRANSNATIONAL BANKING INSTITUTIONS

**MARCH 1992**

## THE SUPERINTENDENT'S ADVISORY COMMITTEE ON TRANSNATIONAL BANKING INSTITUTIONS

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Superintendent of Banks



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**STAFF OF THE**
**THE SUPERINTENDENT'S ADVISORY COMMITTEE**
**ON TRANSNATIONAL BANKING INSTITUTIONS**

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Rosenman & Colin

Nancy A. Ameen
White & Case

Donald Billings
KPMG Peat Marwick

Ronald F. Daitz
Weil Gotshall & Manges

Albert V. De Leon
National Westminster Bancorp Inc.

Arthur Gelman
First Assistant Counsel
State of New York Banking Department

Lawrence J. Hohlt
Gibson, Dunn & Crutcher

James M. Kindler
Executive Assistant District
Attorney, New York County

Michael J. Lesser
Assistant Deputy Superintendent
of Banks
Foreign Commercial Banks Division
State of New York Banking Department

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Merrill Lynch & Co.

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Vincent Love
Ernst & Young

Robert H. McCormick
Deputy Superintendent of Banks
Foreign Commercial Banks Division
State of New York Banking Department

John Misner
Assistant Deputy
Foreign Commercial Banks Division
State of New York Banking Department

Deborah S. Prutzman
Paul, Weiss, Rifkind, Wharton & Garrison

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Assistant Counsel
State of New York Banking Department

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General Counsel's Office
American Express Company

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Rosenman & Colin

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**SUPERINTENDENT'S ADVISORY COMMITTEE**
**ON TRANSNATIONAL BANKING INSTITUTIONS**

**John G. Heimann**
**Chairman**

March 20, 1992

The Honorable Derrick D. Cephas
Superintendent of Banks
State of New York Banking Department
Two Rector Street
New York, NY 10006

Dear Superintendent Cephas:

On behalf of the Advisory Committee on Transnational Banking Institutions, I am pleased to submit the report of the Committee.

The Committee was established and its members appointed by Governor Mario M. Cuomo on September 10, 1991. Since its first meeting on September 16, 1991, the Committee has solicited public participation in its deliberations, has held six meetings, has received, in response to its invitation, comments from interested members of the public, and on November 18, 1991 held a public hearing. The Committee is indebted to the large number of individuals and organizations that have offered their views.



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The Governor's press release announcing the appointment of the Committee states:

> "Because New York is the world's banking capital, it is essential for us to protect the integrity and financial stability of foreign banks doing business here. The committee will analyze the risks involved in transnational banking and recommend specific actions we need to tighten supervision of these banks."

You summarized the Committee's task as follows:

> "New York State and the Banking Department have thus far managed to avoid undue regulatory difficulties at state-licensed foreign banks. But the increasing use of complex transactions and home country secrecy laws by foreign banking institutions doing business in New York and many other jurisdictions at once makes the task of effective regulation more difficult. Our responsibility is to minimize the attendant regulatory risks as much as possible while still encouraging foreign banking institutions to flourish in New York."

The overriding theme of the Committee's recommendations is that New York State benefits from the wholesale banking business that is done by foreign banks in New York. The business of foreign banks in New York has grown from a relatively small sum twenty years ago to assets of over $600 billion today and trillions of dollars in daily transactions. This level of business has an extremely positive impact on New York's economy and on the position of the United States in international finance.

At the same time, however, ongoing changes in the financial services industry, driven by economic forces, customer expectations, competition and technological developments, present a challenge to bank supervisors to keep pace.

In recent years agreed-upon transnational banking rules have begun to take shape through the Bank for International Settlements at Basle, Switzerland and other multilateral organizations. Generally accepted international capital standards now govern the capital requirements of banks from all major countries, and supervisors are moving toward agreements on other issues involving bank safety and soundness.

The BCCI failure, which took place in the midst of this process, has spurred it forward and has prompted regulatory changes at various levels of government. These changes include the Foreign Bank Supervision Enhancement Act, which was enacted by Congress in November 1991 as part of the Federal Deposit Insurance Corporation Improvement Act. That Act emphasizes international cooperation as a cornerstone of U.S. regulation and supervision of foreign banks doing business here.

The Superintendent's Advisory Committee was created to ensure that New York's regulation and supervision of transnational banks would continue to meet the highest standards. The New York State Banking Department has supervised foreign banks doing business in the United States for longer than any other state or federal regulatory agency and licenses more foreign banks than any other U.S. authority. In fact, New York licenses more foreign banks than any other authority in the world, except the Bank of England. The Banking Department's role therefore is critical to the sound functioning of the international wholesale banking system. Our recommendations are designed to reinforce the safety and soundness of that system, to rededicate New York's commitment to promoting cooperation of banks with law enforcement authorities, and, at the same time, to permit the free international flow of capital. If the Committee has one principal conclusion, it is that because capital markets are integrated worldwide, banks can and will avoid doing business in locations which have high costs and unnecessary overregulation.



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Some of the regulation which the banking business will avoid is not, of course, within the control of state authorities. For example, application of the Bank Holding Company Act to foreign banks that have offices in the United States may force several of them which have integrated their operations withsecurities or insurance firms to curtail or terminate their U.S. banking operations. This would not be beneficial to the U.S. economy.

Speaking for all Committee members, it has been an honor and pleasure to serve the State of New York. We have found the banking laws and the Banking Department's policies on transnational banks to be in generally good order. We hope that our recommendations will help the Department to meet the needs of the future.

Sincerely,

John G. Heimann

# I

## INTRODUCTION

During the past three decades, the world's banking system has become increasingly globalized. Due to technological advances and growing needs to serve customers with multinational operations, banks have established facilities in many countries. As banks have expanded, nations have liberalized their laws to permit freer entry of foreign banks, in recognition of the real domestic economic benefits of foreign bank participation.

This trend continues. The international banking environment in the 1990's is highly competitive, bringing many benefits to the users of the system in the form of more sophisticated services, more competitive services, and, in general, more competitive pricing of those services, ultimately resulting in lower costs and a stronger economy.

To take advantage of major markets and to operate in all time zones, major international banks have expanded into the three financial centers which dominate the world's financial system: New York, London and Tokyo. This tri-polar system is the linchpin of today's financial system representing, as it does, the three main centers of international financial activity.

In spite of the internationalization of banking, bank regulation remains in large part a process conducted under national and state laws. The New York State Banking Department (the "Banking Department") is the most experienced American regulator of foreign banks. Foreign

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banks have been doing business in the State of New York for over 100 years, and for many years the Banking Department was the sole supervisor of foreign banks doing business in the United States. Gradually, other states opened their doors to foreign banks, and in 1978 the International Banking Act ("IBA")[1] authorized the Office of the Comptroller of the Currency (the "OCC") to grant licenses for "federal branches". The IBA also first granted the Federal Reserve Board ("FRB") jurisdiction to examine and supervise foreign branches and agencies.[2] The Foreign Bank Supervision Enhancement Act of 1991 (the "Enhancement Act"), enacted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"),[3] expanded the FRB's powers to include approving and terminating licenses of foreign banks doing business in the United States.

Today 49 out of the largest 50 banks in the world are headquartered outside the United States, and all of them have offices in New York. New York licenses and supervises branches and agencies of over 200 foreign banks from 45 countries which have over $400 billion of assets in New York. In addition, there are over 170 representative offices of foreign banks in New York, and the Banking Department is the chartering authority of 46 commercial banks chartered under Article III of the Banking Law and 12 Article XII companies which are owned or controlled by foreign banks.[4] In all, banks from 64 foreign countries are present in New York. These foreign bank branches, agencies and subsidiaries account for over half of the U.S. assets of foreign banks doing business in the United States, and over two thirds of branch and agency assets. In addition, domestic New York state-chartered banks hold over 50% of the assets of all foreign offices of U.S. banks. As a consequence, the New York Superintendent of Banks remains the principal U.S. licensing authority for transnational



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banks, although the FRB's expanded jurisdiction over all foreign banks in the United States under the Enhancement Act will give it substantially increased authority over the licensing and supervision of foreign banks.

Banking continues to grow in its importance to the economy of New York City and New York State, and foreign banks continue to increase their significance to the wholesale banking markets of the United States generally and of New York in particular. Foreign banks now employ over 100,000 people in the United States, over half of them in the City of New York, and nationally foreign banks lease or own over 35 million square feet of space.[5] The business that foreign banks do in the United States is principally a wholesale banking business, lending to American and foreign businesses, supporting import and export transactions, and participating in the interbank market for deposits and a variety of derivative products designed to hedge interest rate, currency or other financial risks. Only 20 foreign banks accept significant amounts of retail deposits in New York through branches, all of which are insured by the FDIC. The assets of these FDIC-insured branches account for less than 2% of the foreign bank branch and agency assets in New York. In the future, the Enhancement Act will require that foreign banks enter the retail deposit business only through subsidiaries and not through branches.

The wholesale business that predominates the foreign banks' business in New York flourishes because the dollar is the world's principal medium of exchange and because New York is the largest center of dollar activity. This wholesale business has been conducted safely and efficiently under New York supervision. For New York to maintain its position as a financial capital, it is essential for New York to maintain laws

that permit legitimate business to be done as freely as is prudently possible.

The bank regulatory and supervisory laws, rules and policies that govern foreign banks doing business in New York are an important part of the panoply of laws and regulations that determine whether New York is fundamentally an attractive place to do financial business.[6] It is these bank regulatory and supervisory laws, rules and policies on which this Advisory Committee Report focuses. The Committee's task was to review bank regulatory and supervisory matters, not consumer protection, tax or other legal matters that may bear on foreign banks doing business in New York.

The Committee's basic goal is to foster a system of regulation and supervision which leaves foreign banks free to compete and do business in New York on a level playing field with U.S. institutions, while at the same time protecting those who do business with the foreign banks that do business here. The Committee adheres to the principle of national treatment under which banks from other countries are to be treated, as much as possible, the same as banks chartered and owned in the United States.

**Process**

The Committee was appointed by Governor Mario M. Cuomo in September 1991, and met as a whole Committee approximately monthly through February 1992. Much of the work of the Committee has been accomplished through four subcommittees, as follows:



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Criteria For Entry

Michael E. Patterson, Chair
C. Harrison Smith
Joan E. Spero
Ingo Walter

Forms of Organization

George J. Vojta, Chair
H. Rodgin Cohen
Hideo Kitahara

Examination and Supervision

John Tugwell, Chair
Stephen M. Brecher
Hon. Robert M. Morgenthau

Exit and Liquidation

Philip A. Lacovara, Chair
Winfried H. Spaeh

Each subcommittee has had the assistance of several volunteer staff members, who have attended meetings of the subcommittees and the Committee, have written research and position papers on various specific issues, have done field research and interviews, and have contributed importantly to the Committee's work. Representatives of the Banking

Department and the Committee's Chief of Staff have participated in substantially all subcommittee and Committee meetings. The Committee conducted a formal public hearing at which testimony was heard from interested parties, including the Institute of International Bankers and the Public Employees Federation, the labor union which represents the Banking Department's examiners. Less formal contacts have been made with representatives of the Federal Reserve Bank of New York ("FRBNY"), the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Many of the issues that the Committee has considered have cut across subcommittee lines. Questions regarding entry standards, for example, also may have implications for continued licensure, liquidation rules reflect back on examination and supervision issues, and issues of examination and supervision may best be dealt with in the licensing process or by restricting the business in which a form of organization can engage.

Some of the changes recommended by the Committee will require phasing in and negotiation or discussion among regulators. This may be particularly true of areas where the Committee suggests increased cooperation among regulators or that specific regulatory standards be deemed minimum standards or that entry standards should be enforced as ongoing standards after licensing. These are areas where the Banking Department will have to exercise judgment in going forward if it adopts the Committee's recommendations. The Committee believes in general that regulatory flexibility is needed in the international arena.

In addition to being host to offices of major banks from other countries, New York is home to U.S.-based transnational



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banks, and the Committee has considered their interests as well. The Committee recognizes that what U.S. banks may be permitted to do abroad is likely to be related, in the long run, to what foreign banks can do in the U.S. Thus, while the Committee has generally not favored reciprocity standards, it has been cognizant that U.S. treatment of foreign banks will influence how U.S. banks are treated by other countries.

The Committee also recognizes that tax and regulatory issues often are intertwined. Thus, although the Committee has not generally commented on tax issues, in general it supports the concept that tax administration should be consistent with the economic goals of regulation.

This Report contains many recommendations, some of which suggest only minor variations from current practice, others of which the Committee regards as important initiatives. The most important finding of the Committee is that maintaining the branch/agency form is necessary in order to maintain the level of international business done in New York. The Committee firmly believes that if foreign banks were required to do business in subsidiary form, the level of business would decline significantly, which could have a negative impact on the position of the dollar and of the United States in international commerce. In the Committee's view, the subsidiary form is not required by considerations of either safety and soundness or competitive equity.

Additional significant recommendations include:

- Continuation of the New York State Banking Department's important role as a regulator and supervisor of transnational banks.

- Steps to promote cooperation among supervisors both domestically and internationally.

- Policies that prevent foreign bank secrecy laws from defeating United States criminal investigations.

- Clarifying the test for when liabilities of a foreign bank will be deemed liabilities of its New York branch/agency in liquidation.

- Providing the Banking Department with an independent budget so that it can hire and retain appropriately experienced personnel and supervise banks properly in a complex financial world.

**Branches, Agencies and Subsidiaries**

One of the factors that makes New York attractive to foreign banks that desire to do wholesale business is the availability of the branch and agency forms of doing business. When a bank (whether U.S. or foreign) establishes a subsidiary bank in a foreign location it generally must allocate specific capital to that subsidiary and may be legally restricted in its dealings with that subsidiary. By contrast, a branch or agency is an integral part of the bank itself; generally a branch/agency therefore requires no separate capital of its own and is free to



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deal with the home office and other branches of the bank without restriction. A subsidiary is by legal definition an entity that can survive or fail independent of its owners. A branch or agency, by contrast, rather than being treated as if it were a separate entity, has the entire worldwide capital of the bank behind its transactions and its lending limit (the regulatory limit on the size of loans that it may extend to one borrower) is based on the bank's worldwide capital, rather than on the capital allocated to it, as would be the case for a subsidiary. Because of this distinction, a branch or agency can do a larger and more varied business than a subsidiary, and its ability to engage in international commerce on behalf of the bank is greater than a subsidiary's would be. Indeed, as a consequence of branch/agency flexibility, most foreign banks that maintain subsidiaries in New York to conduct domestic American business also maintain a branch or agency which engages primarily in international and interbank transactions.

The ability of foreign banks to do business through branches and agencies is, for these reasons, important to them, and, because of the preponderant wholesale nature of the business done by New York branches and agencies, important to New York and its economy. The Committee further believes that the greater access to international credit markets that the branch/agency form affords to businesses in the United States is beneficial to the American economy as a whole. Indeed, the Committee believes that withdrawal of significant amounts of lendable funds by foreign banks (which account for over 25% of commercial and industrial loans made by banks in the United States) would have a negative impact on the economy of the United States.

The branch/agency form has been questioned, however, on the ground that it is more difficult for a United States

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regulator to protect persons and entities that dealt with a United States branch/agency of a foreign bank that fails than it would be to protect those who had dealt with a subsidiary. A subsidiary, it is said, has its own capital, its own clearly demarcated assets and liabilities, is restricted in its dealings with its parent bank, and stands or falls on its own financial condition. A branch or agency, by contrast, does not have its own legal capital, is relatively free to deal with its home office and other branch offices, and will fail if the bank as a whole fails.

These differences lead some to advocate requiring all foreign bank business in the United States to be done through subsidiaries (or representative offices which themselves do not make loans or accept deposits).[7] The Committee does not believe such a restrictive position is warranted or productive. There have been very few failures of foreign banks with offices in the United States, and unless the home office refuses to or cannot honor branch obligations, a branch/agency cannot fail on its own; it only fails when the bank as a whole fails.

In New York only a few branches/agencies of foreign banks have been liquidated in the over 100 years that they have done business, and only three of them since 1945.[8] In the first two post-1945 liquidations, all New York creditors were paid in full and a surplus was provided to the home country liquidator. In the third liquidation, BCCI, which is proceeding now, the Superintendent believes that the result will be the same.[9]

It is distinctly preferable to have a bank's worldwide capital and the worldwide diversification of its assets stand behind its U.S. obligations than to have, in the case of a subsidiary form of organization, a smaller amount of designated capital and less diversified assets behind them. Whatever



benefits one may see in the subsidiary form are outweighed by the benefits of the branch form. U.S. branches and agencies of foreign banks have not proved to be dangerous to their creditors and counterparties.

As pointed out above, requiring business to be done through subsidiaries would have a significant adverse impact on the international banking business done in the United States and could result in the withdrawal of capital from U.S. markets. In addition, restricting the use of the branch form in the United States could have an adverse impact on U.S. banks which conduct business in many foreign countries through the branch form, because other countries might be influenced to adopt similar rules. U.S. banks operating abroad value the branch form no less than foreign banks operating in the United States. (International agreements, such as those which may result from the Uruguay Round of the GATT, also may have an impact on how the United States regulates foreign banks and on how other countries regulate U.S. banks.)

By December 19, 1992, FDICIA requires the Secretary of the Treasury and the Federal Reserve Board, "in consultation with" the Comptroller of the Currency, the FDIC and the Attorney General of the United States, to conduct a "study of whether foreign banks should be required to conduct banking operations in the United States through subsidiaries rather than branches."[10] The Committee hopes that in preparing their report the Secretary of the Treasury and the Federal Reserve Board will consider and take into account this Committee's conclusions.

The Committee believes that continuing to permit and encourage the branch/agency form of doing business is consistent with current practice in the European Community

("EC"), which, in its Second Banking Directive, has opted for a system under which branching throughout the EC countries, with approval only from the home country regulator, is the rule.[11] The EC countries have agreed to trust each other's regulatory authorities to protect depositors throughout the EC in terms of ultimate bank health. A U.S. bank that does business in the EC has a choice of obtaining approval to operate through branches or establishing a subsidiary in an EC country which will qualify to be treated as an EC-based bank which can operate throughout the Community.

**International Cooperation**

The BCCI affair is a reminder that there are potential dangers from transnational banking organizations, even though it appears that New York creditors will be fully protected in that case. And the BCCI affair has focused greater attention on cooperation among supervisors.

As early as 1983, however, the Committee on Banking Regulation and Supervisory Practices of the Bank for International Settlements ("BIS") recognized in its report known as the "Basle Concordat", which established principles for the supervision of foreign offices of banks, that effective cooperation between host and home country regulators is "a central prerequisite for the supervision of banks' international operations." In giving effect to these principles, the Concordat recommended both that host country regulators ensure that home country regulators are informed of any serious problems which arise in a bank's foreign offices and, concomitantly, that home country regulators inform host country regulators when problems arise in a bank that are likely to affect its foreign offices. The Concordat has been endorsed by approximately 75



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supervisory authorities in addition to those in the G-10 countries.[12]

It is important that these principles of international cooperation be implemented, since they are the foundation on which international bank supervision should be built. However, in order for there truly to be international cooperation, regulators need to overcome their reluctance to consult with each other concerning potential problems. (FDICIA encourages exchanges of information between home country and host country supervisors, and, in order to promote exchanges of information, a recommendation concerning enhanced confidentiality is contained in this Report.)

In this connection, in April 1990, the BIS Committee published a Supplement to its Concordat of 1983 to promote adequate information flows between bank supervisory authorities. The Supplement recommended that (i) when an application by a bank to establish a new foreign presence is made, the authorization procedure employed by home and host country regulators should be used to create the basis for collaboration between them in the future; (ii) the information needs of home country regulators should be met by requiring banks to develop a system of reporting, capable of verification, from foreign office to head office or parent bank; (iii) the information needs of host country regulators should be met by home country regulators first apprising the former of the extent to which foreign offices will be monitored at home and then keeping the host country regulators informed of matters abroad that may affect the foreign offices; (iv) national secrecy laws should be amended to enable national supervisors to exchange information with their fellow supervisors abroad on certain strict conditions; and (v) all foreign offices should be subject to external audit. The Committee is in agreement with these

principles and in this Report seeks to assist in implementing them.[13]

Despite the Concordat and its Supplement, the exchange of information between many countries' regulators is not consistent or highly structured. In most cases the exchange of information takes place entirely through bilateral regulatory contacts. It can be difficult for a supervisor which hosts banks from many nations to maintain suitable bilateral contacts with all of them. Banks from 64 countries, for example, currently do business in New York, and it is expected that banks from additional countries, including former communist bloc countries, will seek to do so in the near future.

The Committee considered whether to recommend that an international "congress of regulators" should be created, under the aegis of the BIS or otherwise, to facilitate the interchange of information so that home country and host country regulators could assist each other in a more systematic way than can be done through the existing system of multilateral and bilateral contacts. The Committee stopped short of recommending that systematic interchange be institutionalized through an existing or new international body at this time. The current system can be augmented with improved bilateral contacts, more international fora for discussion of regulatory and supervisory issues, and increased cooperation. Certainly the process can begin by host country supervisors assisting home country supervisors by making information on branch examinations or reviews available more readily than at present. To the extent practicable, duplicate supervision of branches should be avoided by home and host country supervisors exchanging information.



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Because it is the only major supervisor of international banks that is not an arm of a sovereign nation, the Banking Department has a special difficulty in playing its appropriate role in international exchanges of information. This factor has not, however, prevented close cooperation between the New York Banking Department and bank regulatory agencies in other countries in the past, and it should not prevent New York from expanding its bilateral relationships.

As international bodies evolve to deal with information interchange among bank supervisors, New York's banking supervisors should be included in the process, either directly or as representatives of states which supervise branches of foreign banks, since it is among the major supervisors of international banks. Although the Federal Reserve System's jurisdiction overlaps with New York's, New York's jurisdiction is separate, and it is New York law, not federal law, which governs many branch and agency attributes, including, ultimately, their liquidation. To enhance its ability to deal with international issues, the Banking Department should promote international cooperation by hosting seminars and by offering internship programs for foreign regulators. Banking Department personnel should visit regularly with home country regulators and regulators whose countries host New York institutions to establish or expand relationships. Playing an appropriate international role, the Committee recognizes, will impose costs on the Banking Department for which it will need additional funding, as will be recommended below.

## Cooperation Among U.S. Regulators

To gain supervisory efficiency and to reduce the burden of regulation where possible, improved cooperation among United States supervisors also is desirable. To the extent

possible, basic standards applied by the states which license the largest numbers of foreign branches/agencies and by the OCC, which licenses federal branches/agencies, should be uniform. Banks coming to the U.S. should not be able to shop for the most lenient regulator. The Committee believes that the OCC is prepared to cooperate with the Superintendent in fashioning appropriate rules so as to avoid any such possibility.

The roles of the states tend to be somewhat difficult to coordinate in the international banking field. The states are useful supervisors in that their understanding of local economic interests naturally becomes part of their supervisory process. A regulator with jurisdiction throughout the United States cannot be as sensitive to these issues. The Banking Department, for example, has very usefully provided an approachable official link to the foreign banking community. As a whole, however, most state bank supervisors have not had reason to devote similar resources to foreign banks. Fewer than a dozen states have any material number of foreign banks licensed to do business; as a consequence, it is difficult for the Conference of State Bank Supervisors ("CSBS") to play its proper liaison role. The Committee would encourage more active coordination by an interested subset of the CSBS, which already has begun through an information-sharing agreement among California, Florida, Georgia, Illinois, Michigan, New York, and Washington. If the states are to play a significant role in setting national and international policy in the regulation and supervision of banks, it is likely that they must do so by selecting representatives. New York is clearly the international leader among the states but it is more likely to have significant influence and gain access to important committees as a representative of the states in general.[14] In addition, cooperation among the states might permit coordinated examinations of foreign banks which have multiple U.S.



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branches, which would create a more complete picture of U.S. operations.

In future years, the key cooperation in the supervision of foreign banks will be between state regulators and the Federal Reserve System. The Committee notes that the Banking Department and the FRBNY have conducted joint examinations of foreign branches/agencies for the past several years and the Committee encourages this cooperation to grow so that the Federal Reserve's new responsibilities under the Enhancement Act do not unnecessarily burden foreign banks doing business in New York.[15] Joint annual examinations are planned by the two agencies, and the Committee endorses formalized joint examination.

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## II

## CRITERIA FOR ENTRY

The New York Banking Law (the "Banking Law") provides authority for the Superintendent of Banks, on approval of the New York State Banking Board (the "Banking Board"), to grant licenses to foreign banks to operate branches and agencies in the State of New York.[16] Sections 200 and 201 of the Banking Law provide technical requirements for foreign banks to comply with, including the proposed office being in compliance with the laws of its home country, furnishing financial information required by the Superintendent, and submitting to legal process in New York. The Superintendent has developed additional relevant criteria under which licenses may be granted.

The Enhancement Act is more specific than the Banking Law in establishing the criteria that the Federal Reserve Board is to apply in exercising its authority to approve licenses for branches and agencies: "The Board may not approve an application ... unless it determines that -

> "(A) the foreign bank ... is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country; and
>
> (B) the foreign bank has furnished the Board the information it needs to adequately assess the application."[17]

The statute goes on to specify what the Board "may take into account":



> "(A) whether the appropriate authorities in the home country of the foreign bank have consented to the proposed establishment of a branch, agency or commercial lending company in the United States by the foreign bank;
>
> (B) the financial and managerial resources of the foreign bank, including the bank's experience and capacity to engage in international banking;
>
> (C) whether the foreign bank has provided the Board with adequate assurances that the bank will make available to the Board such information on the operations or activities of the foreign bank and any affiliate of the bank that the Board deems necessary to determine and enforce compliance with this Act, the Bank Holding Company Act of 1956, and other applicable Federal law; and
>
> (D) whether the foreign bank and the United States affiliates of the bank are in compliance with applicable United States law."[18]

The criteria that the Banking Department has developed are similar to the criteria contained in the federal statute but they are somewhat more extensive. The Banking Department's criteria, which have been utilized for several years, include:

1. Permission for opening of a branch or agency from a bank's home country regulator.
2. Consideration of the size and significance of the bank in relation to other banks in the home

country and worldwide. (Generally at least $1 billion of worldwide assets for the bank.)

3. Consideration of the financial condition and political stability of an applicant's country. The policy generally requires asset maintenance for institutions from countries with weak or troubled economies.

4. Consideration of the nature of home country supervision.

5. Requirement that generally banks maintain risk-weighted capital consistent with international standards (BIS).

6. Reference checks from other banks in New York and from banks and regulators in other countries in which the bank has a presence.

7. Requirement of an investigation of the individuals or groups that control the bank.

8. Requirement of a credible business plan and profitability projections. Applicants generally are required to be profitable in 4 to 5 years. The foreign bank must have a successful track record in its home country, usually five years at least.

9. Review of the qualifications of the proposed senior managers of the New York office.

The Committee believes that the key criteria are those related to (1) home country economic and political stability, (2)



the quality of home country supervision, (3) financial strength of the bank, as indicated in part by its capital position, (4) the quality and character of the bank's management, and (5) the character of the bank's ownership.

**Evaluating Home Country Supervision**

The character and quality of home country supervision, a factor which the federal statute spotlights, may present the most difficult set of standards to apply. These standards involve not only the extent of supervision ("consolidated" and "comprehensive" in the language of the federal statute), but also how well that supervision is performed and the degree to which the supervisor is willing to provide information to other supervisors that need to know about the health and standing of the bank on an on-going basis. Minimum standards are required because one of the key failings in the supervision of BCCI appears to have been the lack of a responsible consolidated home country supervisor.

"Consolidated" supervision refers to supervision cutting across branch and entity lines so that the supervisor has a view not only of the banking operations under its immediate jurisdiction, but also of operations that may be performed through branches abroad or subsidiaries at home or abroad. Given the complexity of many corporate structures, the notion of consolidated supervision raises questions about how far up, how far to the side, and how far down the corporate or control tree the supervision must go in order to qualify as "consolidated".

The Federal Reserve Board, possibly in cooperation with the BIS or other international organizations, will have to decide the meaning of "consolidated" for federal law purposes. The



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Committee believes that eventually a definition should be adopted internationally, which all bank supervisory agencies will then accept as a minimum standard.

The Committee recommends a standard of consolidation which includes supervision of the bank, all of its branches, wherever located, and all of its investments, including subsidiaries, wherever located. Although this standard does not generally require supervision of companies which control the bank or companies under common control with the bank but not in the bank's chain of control, in cases where a holding company is the only controlling element in a banking group, holding company supervision by a home country supervisor may be required to assure consolidated supervision of all banking entities in the group.

This recommended definition of "consolidated" presupposes that, when a holding company is not supervised, the home country supervisor regulates transactions between the bank and controlling persons or entities and entities under common control.[19] Historically, transactions with affiliates and related parties have been the cause of many major bank failures; as a consequence, it is tempting to suggest that in order to have consolidated supervision, no affiliate can go unsupervised. In practice, however, few supervisors would have the authority to effect such broad supervision, and supervising transactions with affiliates can provide satisfactory protection. Even in the United States, where the most consolidated supervision is practiced and holding companies are supervised, corporations which may be commonly controlled with a bank through individual ownership are not subject to any form of supervision, although transactions with them are subject to restrictions.



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Defining "comprehensive" supervision is more difficult still, and again the Federal Reserve Board will have to formulate a working definition in order to exercise its powers under the Enhancement Act. The difficulty here stems from the extremely wide range of supervisory tools used by different respected supervisors. The United States practice, whether at the state or federal level, is to base bank supervision on a periodic on-site examination of the bank. Orders and directives, whether formal or informal, are based on the findings made in such examinations. New York applies this method of supervision to branches and agencies of foreign banks as well, and the Federal Reserve will be required to do the same under the Enhancement Act. Many other countries, however, do not conduct regular on-site examinations. Instead of on-site examination, some foreign regulators rely on outside auditing firms, which in many cases are required to address their audit reports directly to the bank supervisory authority as well as to the board of directors or other governing body of the bank.

The Committee does not believe that it would be realistic or productive for United States regulators to require home country regulators to conduct on-site examinations in order to qualify under the "comprehensive" standard. The lack of such examinations does not necessarily indicate that a supervisor's processes are not sufficiently comprehensive. For example, the Bank of England relies on supervisory staff evaluations of senior management of the bank and their character and command of operations to supplement independent auditors' on-site findings. And some European central banks which may not engage in on-site examination have a tradition of not permitting a major bank to fail, thereby incidentally protecting those who had dealt with the foreign (including United States) branches of those banks, regardless of

whether the home country deposit insurance system required that result.[20]

Given the world-wide diversity of means of supervision, the Committee recommends that the Banking Department should be satisfied that a home country supervisor's processes and procedures are designed reasonably to assure that the supervisor know the bank's financial condition, including capital position and asset quality, and the bank's management capability, on a current basis. The Committee urges that, over time, processes and procedures that are internationally acceptable be developed and widely adopted. Exchange of ideas on this subject appears to be taking place and is one of the positive results of the BCCI debacle.

In addition to the formal requirements that home country supervision be consolidated and comprehensive, the Committee recognizes that different supervisors in fact will function at different levels and therefore that the quality or competence of home country supervision will vary. Ideally, the quality of home country supervision should be evaluated by an international group of supervisors, who would be in a position to encourage steps to strengthen supervision when it was deficient. Lacking such an international body, the Superintendent should, in cooperation with the Federal Reserve System, seek to evaluate supervision in countries whose banks seek admission to New York for the first time. Because granting a branch or agency license places reliance on the quality of home country supervision to protect those who deal with the New York office, minimum standards must be enforced.

Finally, it would be useful for the Superintendent to apply a minimum standard of cooperation from the home



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country supervisor. The supervisor may do an excellent job but a bank under its supervision may nevertheless weaken financially, and it is important that host country supervisors who have licensed branches or agencies know when the bank's finances or standing have declined. Yet the history of cooperation of this sort is spotty. Some foreign supervisors provide fairly early warnings of financial weaknesses, as the Supplement to the Basle Concordat contemplates; others do not. A formal international interchange system would be useful to provide greater uniformity; but at the present time the Superintendent should seek assurances of cooperation from the home country supervisor as a condition of entry. FDICIA permits the Federal Reserve Board to do this as well, and the Committee believes that New York, the Federal Reserve and the OCC could usefully arrive at common requirements.

To encourage cooperation, the Committee recommends that New York enact a statute which permits the Superintendent to accord the same standard of confidentiality to information received from foreign bank supervisors that is accorded to examination reports and related materials generated by the Banking Department.[21]

The Committee notes that the international banking community usually perceives a bank's weakness as early as its supervisor does, and that monitoring the levels of a bank's access to credit lines or deposits of other banks may provide an early warning of potential problems. The Committee recommends that the Banking Department continue and expand its uses of banking sources as a means of monitoring the financial strength of foreign banks with licensed offices in New York. A periodic survey of access to wholesale markets may be useful.

## Financial Strength of the Bank

In the past it has been difficult for U.S. bank regulatory authorities to evaluate the financial strength of some of the banks that have applied for licenses to establish offices in the United States. Different accounting conventions, systems of "hidden reserves", bank secrecy laws, and a view in many parts of the world that banking should not be a wholly transparent business made it difficult to evaluate the financial strength of many foreign banks. Although differences in accounting conventions and systems of "hidden reserves" remain in some cases, the BIS capital standards and the need to interpret those standards uniformly have made measurement of financial strength more practicable. In addition, bank secrecy laws have been modified in many countries in recent years, and events such as the failure of BCCI have demonstrated that bank supervisors who permit secrecy or discretion to inhibit investigation can encourage illegal conduct, money laundering, fraud and abuse. While BIS capital standards may never amount to a bright-line test of financial strength, they are a significant step forward and, if greater accounting uniformity (including evaluation of reserves for bad debts) can be encouraged by the same means, they should lead to a reliable test. The Enhancement Act requires that the Federal Reserve Board and the Secretary of the Treasury submit a report to Congress on adjustments necessary to make foreign bank capital equivalent to U.S. bank capital under BIS standards;[22] this study may permit better equivalency measures in the future. At the present time, the Committee believes that unadjusted BIS capital standards are the best standards available and should be applied as an entry standard on all branch/agency applications, provided that the Banking Department believes that the accounting standards utilized are reasonably designed to reflect economic reality. If the Banking Department cannot reasonably

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determine a bank's capital, the Committee believes that branch/agency approvals should be withheld.

Using the BIS capital standards on entry implies that they should be used as a standard of good standing on an on-going basis. Therefore mechanisms should be established on entry to assure that the Banking Department will have prompt periodic notification of BIS capital levels of banks doing business in New York. If a bank falls below BIS capital standards, the Superintendent should seek to establish a coordinated remedial program with the home country regulator. Continued or drastic failure to meet standards could, however, cause the Superintendent to restrict activities, terminate a bank's license or take over the branch or agency.[23]

Some banks that are owned by sovereign states suggest that they should not be required to meet BIS capital standards because in essence the state stands behind the bank. The Committee does not believe an exception should be created for this category of banks. First, in many cases the liability of the sovereign country for the debts of the bank is not much clearer than the tradition of the central banks in many countries of propping up banks which become weak.[24] Second, to operate without capital reduces the discipline imposed on a bank and is, in the Committee's view, inherently unsound. Third, a level playing field and a perception that the playing field is level are important principles that an exception to the BIS standards would breach. The Committee's position is consistent with the position taken by the BIS on this issue.

## Management

The quality and character of management are key to a bank's long-term financial health. A host country regulator,

however, in the first instance, generally relies on the home country regulator for information and monitoring of management. In the absence of specific concerns, it is sufficient for the Banking Department to evaluate reports on home country management and to obtain background checks on and meet with proposed managers of the New York office and evaluate them as representatives of the home country management.

**Ownership**

Although the Committee concluded that consolidated supervision did not necessarily include ongoing supervision of owners, the Committee believes that evaluating controlling owners is extremely important. It is the controlling owners who set the ultimate tone for the bank, and when fraudulent or illegal transactions have been a part of the fabric of a bank's operations, they usually can be traced to the purposes of those owners. Accordingly, before granting licenses the Superintendent should be satisfied that the true owners of the bank are known and that, based on information from reliable sources, they are engaged in legitimate business and have no connections to criminal elements. Access to the global banking system frequently is necessary for criminal elements to translate the fruits of crime into apparently legitimate wealth, and the banking authorities should continue their strong efforts to prevent criminal elements from gaining access to the banking system.

As will be described below, the Committee recommends that the review of ownership at time of entry be reinforced by authority over changes in control.



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**Bank Secrecy**

Historically, banking secrecy in the United States has differed in practice from a number of European countries, and particularly from a number of tax haven jurisdictions. Under American practice, bank information concerning customer accounts and transactions is available to law enforcement authorities through their subpoena power. And the federal Bank Secrecy Act is in fact a bank non-secrecy act in that it specifies the circumstances under which banks must retain data and make information available.[25]

Prosecutors in United States jurisdictions believe that a foreign bank should not be able to do business in the United States through a branch or agency yet claim that its home country laws do not permit it to divulge information regarding customers who are suspected or accused of having committed crimes in the United States. In fact progress has been made in providing United States prosecutors with access to such information. Several bilateral treaties give United States prosecutors access to account information regarding U.S. citizens or residents who are suspected of crimes, and some countries, notably Switzerland, have enacted laws which enable banks to cooperate, such as by requiring that banks know their customers. In some secrecy jurisdictions, however, acquiring information about transactions and accounts affecting the United States is still a problem for U.S. law enforcement officials.

The Committee considers it appropriate for the Banking Department to use regulatory pressures to influence foreign bankers and regulators to effect desirable changes in secrecy laws and to make information available to New York law

enforcement authorities on a reasonable basis. The Banking Department should seek to promote not only the existence of adequate treaties and laws, but also cooperative attitudes and practices of foreign regulators and banks in this area.

The Committee has sought an appropriate benchmark for New York to establish as a standard to expect bank secrecy countries to meet if their banks want access to the New York market. The Committee finds that the U.S.-Swiss treaty and the laws of Switzerland are an appropriate benchmark, since through this system of laws U.S. law enforcement authorities can gain access to account information. Because they have to go through the U.S. Department of Justice, the Swiss authorities, and in some cases the U.S. State Department and the Swiss courts, many U.S. prosecutors find these procedures cumbersome. The U.S.-Swiss treaty also does not cover criminal tax cases not involving fraud, which should not be excluded. Nonetheless, in a general way the U.S.-Swiss arrangements provide a basic standard which could be universally enforced. This standard also could be adopted by the Federal Reserve Board under the Enhancement Act, which explicitly permits the Board to consider future availability of information as an entry requirement.[26]

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**Other Criteria**

All the Superintendent's criteria listed above for approving branch and agency licenses seem appropriate to the Committee. In addition, the Committee recommends that some formal matters that have been taken as assumptions be formalized. The Superintendent should, for example, require that banks seeking branch/agency authority affirm that the bank's worldwide capital stands behind New York office liabilities. The Bank of England has a similar practice. The



affirmation that the bank's worldwide capital stands behind the liabilities of the New York office would affirm a fundamental premise on which branches/agencies are welcomed to do business. In practice, the affirmation would ultimately have to be enforced in the bank's home country, where its enforceability may be subject to local considerations of public policy, but except in extreme situations, such as where U.S.-based assets are embargoed or frozen, an affirmation should be enforceable.

**Country Risk**

The instability of the financial or political system of a bank's home country can pose risks to the bank's solvency or ability to function. Historically, Superintendents of Banks have admitted well-capitalized, well-managed banks from countries with uncertain financial systems subject to a form of regulatory restraint known as "asset maintenance".[27] The Committee has considered whether this policy is prudent or whether banks from such countries should be denied admission as branches/agencies. The Committee has concluded that the Banking Department's current policy is appropriate, especially in light of foreign banks' excellent record in New York.

First, the banks that fall into this category are in New York largely to facilitate trade between their own countries and the United States. If at all possible, this trade should be encouraged. Second, keeping such banks out of New York would encourage trade to flow in other directions, so that as the subject countries achieve greater stability and play a larger role in international trade, their emphasis will be elsewhere, to the detriment of New York and the United States. Third, although some may think entry by such banks in the bank subsidiary form may be safer, the Committee believes that the asserted greater safety of the subsidiary form has not been demonstrated and

that in practice requiring the subsidiary form would exclude many such banks or would so reduce the amount of business that they would do in New York that it would amount to exclusion. Fourth, with the improvements in asset maintenance that will be discussed below, the Committee believes that the Banking Department can assure a reasonable degree of safety.

The Committee does not believe that New York should admit banks that are themselves weak financially or that have weak management, even subject to stringent asset maintenance. And if a country's financial weakness (e.g., the weakness of its currency) is so extreme that its banks are inherently weak, the Banking Department should seek to persuade those banks to do business through representative offices until greater home country financial stability has been achieved.

Country risk should continue to be an on-going concern of the Banking Department, and it should impose asset maintenance or other protective measures on banks from countries whose financial or political systems may, from time to time, appear unstable or illiquid. As a representative of the CSBS, New York is a non-voting member of the Interagency Country Exposure Review Committee ("ICERC"), and therefore has access to the country risk data utilized by the federal agencies.

<u>**Representative Offices**</u>

A representative office is the lowest-risk type of office for a foreign-bank to open. Its powers are extremely limited; it has no power to take deposits or credit balances or even to make loans for its own account. A representative office is prohibited from engaging directly in the business of banking. In essence it is a liaison between the bank and the business



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community where the representative office is established. Representative offices often have been used as a first step toward a future branch or agency.

New York law does not currently require that representative offices of banks with $500 million or more of assets be licensed, examined or supervised by the Banking Department;[28] but the Banking Department proposed a bill to the New York State Legislature in 1991 that would require licensing, examination and supervision, and it is expected that such a bill will be enacted in 1992.[29] Meanwhile, the Enhancement Act has provided that "No foreign bank may establish a representative office without the prior approval of the [Federal Reserve] Board" and that "In acting on any applications under this paragraph to establish a representative office, the Board shall take into account the standards [that the bank be 'subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country'] and may impose any additional requirements that the Board determines to be necessary to carry out the purposes of this Act."[30]

The Committee is of the view that entry as a representative office, while appropriately subject to approval and supervision, should be easier than entry as a branch/agency or through a subsidiary bank or other company conducting a banking business. The Committee believes that sound, well-managed banks from countries that may not have bank supervision that meets all internationally accepted standards should be permitted the type of limited access to the market through representative offices. The Committee hopes in this regard that the Federal Reserve Board will construe its mandate flexibly and not read the requirement that it take standards "into account" as a requirement that those standards

must be met in all cases. Representative offices are a useful way for banks with little international experience to gain that experience and thereby in the long run to enhance trade and to bring their home countries into conformity with global standards. The most important criteria for representative office entry, the Committee believes, are that the bank have a sound plan as to the business that it hopes to generate through the representative office, that the plan not involve the solicitation of retail deposits or effectively running an offshore branch, and that the bank have a reputation for integrity in other places where it does business. The Committee recommends that the Superintendent apply these criteria.

**Regulatory Flexibility**

The Committee does not recommend that criteria for entry be enacted by statute. The Superintendent, with Banking Board approval where required, should have discretion to admit banks or reject applications and to formulate standards. The standards should, however, be known to the banking community generally, and therefore they should be promulgated formally. It would be useful for Sections 200 and 201 of the Banking Law to be simplified to explicitly grant such power to the Superintendent.

**Phase-In For Existing Offices**

The foregoing recommendations regarding standards for entry contain some criteria which the Superintendent has not applied to entrants in the past. To the extent possible, the Committee recommends that the Superintendent seek to apply these standards to banks already doing business in New York. Clearly this process will take a number of years, and banks should be afforded time to come into conformity. However,



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eventually, all foreign banks in New York should be adhering to the same rules and standards.

## III

## FORMS OF ORGANIZATION AVAILABLE

New York currently offers foreign banks a choice among five different forms of organization for New York banking operations: a branch, an agency, a representative office, a subsidiary bank or trust company, and an Article XII investment company. Each of these forms of organization has different powers and is subject to different regulation and supervision.[31]

Subsidiary banks and Article XII investment companies owned by foreign banks are treated no differently from similar entities owned by U.S.-based companies, thus adhering strictly to the principle of national treatment. The Committee does not recommend any change in this regard. The Committee does, however, recommend minor changes in the Article XII form of organization which would apply regardless of whether its ownership was domestic or foreign. The Committee also recommends changes in the agency form, which could result in its being no different from the branch form, and supports the legislation regarding representative offices which was proposed by the Banking Department in 1991, with some amendments.

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**Branch**

A New York branch is an office of a foreign bank that is licensed by the Superintendent to conduct a banking business in New York. The Banking Department has, for many years, interpreted the New York Banking Law to authorize branches of foreign banks to exercise the same powers as state-chartered commercial banks, except as expressly limited by the Banking



Law or their own charters or home country laws. Branches may, for example, accept deposits, make loans, issue letters of credit, deal in foreign exchange, make acceptances and, if authorized, exercise fiduciary (trust) powers. A branch may conduct a retail banking business in New York, making consumer loans and accepting consumer deposits. Since 1978, however, a branch has not been permitted to accept consumer deposits on more than a de minimis basis unless it had FDIC insurance.[32] The New York branches of only 20 foreign banks are FDIC-insured, since the vast majority of foreign banks' branches limit their business to foreign and wholesale banking. The Committee concurs that a foreign bank doing business as a branch/agency in New York should continue to have the same powers as a New York bank, so far as New York law is concerned.

FDICIA has limited the powers of state-chartered banks, regardless of their ownership, and of state-licensed branches/agencies of foreign banks. FDICIA requires, with some limited exceptions, that, when acting as principal, state-chartered banks exercise only the powers of a national bank. It limits the activities of a state-licensed branch to those permitted a federal branch (which are based on the powers of a national bank), unless (1) the Federal Reserve Board has approved the activity, and (2) in the case of an insured branch, the FDIC has given its approval.[33] State-licensed foreign bank branches/agencies therefore are subject to both state and federal restrictions, with attendant potential for confusion, particularly on matters for which both the OCC and the Banking Department have previously established different regulatory regimens. The Committee believes that in general this overlap should not cause undue confusion, so long as the Banking Department and the OCC work together to achieve a uniform federal-state approach. It may be that this will be a

simple process, because the Committee is advised that the only wholesale banking power presently exercised by New York branches and not by federal branches is the power to trade in platinum as well as in gold and silver. The Committee recommends that if other issues arise, perhaps the Banking Department and the OCC should survey banks with branches in New York to find out what powers issues they perceive. The Banking Department and the OCC could then decide those issues and, to the extent that they posed difficult questions, could ask for additional information from affected parties before undertaking a second round of decision-making.

One important conflict between the New York and federal approaches has been the limitation on loans made to a single borrower by a branch. Under the Banking Law, a branch of a foreign bank generally may lend to a single borrower up to 15% of the entire bank's capital and surplus if the loan is unsecured, and may extend an additional amount equal to 10% of its capital and surplus if the loan is secured. These lending limit restrictions are calculated as a percentage of the paid-in capital stock, surplus and undivided profits of the non-U.S. bank.[34] An agency has no lending limit. However, as a result of the Enhancement Act, a state branch or agency also will be subject to the lending limit for a federal branch or agency, which applies the same percentage limitations as New York applies to branches but based on a different aggregation of interests in loans.[35] Specifically, the federal lending limit, which is the same as that applied to national banks, counts the loans made to the same borrower and certain related borrowers by all of the bank's federal branches and agencies in the aggregate. By contrast, a New York branch of a foreign bank has not been required to aggregate its loans to a borrower with loans made to the same borrower by any other U.S.-based branches/agencies of the same bank.

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The Committee agrees with the federal view that loans made by all unincorporated U.S. offices of foreign banks should be aggregated for loan-to-one-borrower-rule purposes.

The Enhancement Act creates an uncertainty as to the ability of foreign banks to accept deposits through U.S. branches. Prior to the Enhancement Act, it was clear that a branch could not accept retail deposits of less than $100,000 unless the branch was FDIC-insured. "Retail" was defined for this purpose in a manner that was sufficiently flexible to permit normal operations of most foreign bank branches. The FDIC's and the OCC's regulations defined "domestic retail deposit activity" (that is, the activity requiring deposit insurance) as "the acceptance by a State branch of any initial deposit of less than $100,000". These regulations also exempted other specified types of deposits (business, government, foreign source and de minimis deposits) from the deposit insurance requirements even if their initial amount was less than $100,000. As a consequence, branches of foreign banks that were not FDIC-insured still could engage in foreign and wholesale banking, as well as a de minimis amount of retail business.[36]

The Enhancement Act has caused considerable confusion because it provides that a branch of a foreign bank cannot maintain deposit accounts with balances of less than $100,000 unless the branch was FDIC-insured on the date of the bill's enactment (December 19, 1991).[37] The Committee does not believe that Congress reasonably could have meant this provision to be taken literally.[38] Even wholesale deposits routinely fall below $100,000 but nevertheless retain their wholesale character. The Committee does not oppose the apparent spirit of the Enhancement Act provision -- that retail deposits of U.S. residents should be insured and the FDIC should not insure additional branches of foreign banks -- but

believes that deposits under $100,000 that would be exempt under the FDIC and OCC regulations were not intended to be covered by this policy. The Federal Reserve Board and the OCC have announced that branches of foreign banks may continue to accept deposits under the regulations in effect prior to December 20, 1991, until regulations clarifying the new requirements of the Enhancement Act are adopted.[39]

The Committee encourages administrative interpretation of this provision to give effect to its apparent intent to affect only retail deposits, as they have been defined. In the alternative, the Committee supports a technical corrections amendment to the Enhancement Act to make clear the apparent Congressional intent of requiring deposit insurance only for "retail" deposits, giving the OCC and FDIC freedom to preserve the existing exemptions. Attached to this Report as Appendix I are letters on this subject submitted by the Committee's Chairman and the Superintendent with the Committee's approval.

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**Agency**

The original distinction between the powers of branches and agencies has eroded considerably during the past ten years. Historically, a foreign bank branch in New York could accept deposits, while an agency could not. This distinction became less important in the early 1980's when the Banking Board authorized New York agencies to issue large-denomination CDs or other obligations.[40] A 1984 amendment to the Banking Law allowed agencies to accept deposits from foreign residents and citizens.[41] In addition, a New York agency may maintain credit balances for its customers incidental to its banking business. A branch continues to be the only method for a foreign bank to accept deposits directly from retail customers



in New York, but this distinction is no longer meaningful, since the Enhancement Act prohibits retail deposit-taking at branches or agencies of foreign banks unless they are already FDIC-insured.

Notwithstanding this convergence in the powers of a branch and agency, an agency has not been subject to some of the "safety and soundness" requirements imposed on branches. Most notably, the lending limit on loans to one borrower and a 5% asset pledge requirement were imposed on branches, but not on agencies.[42]

The Committee believes that agencies should be subject to these two "safety and soundness" requirements. Because the Enhancement Act imposes the OCC lending limit restrictions on New York agencies as well as branches, New York also should apply the same loans-to-one-borrower rules to the two forms of organization. The 5% asset pledge requirement also should be applied to agencies so that, in the event of having to take possession, the Superintendent would have a reliable fund from which to pay the early expenses of the liquidation. (The 5% pledge requirement has not heretofore been applied to IBF deposits. In some cases, this has resulted in branches with large amounts of IBF deposits having virtually no pledge requirement. The Committee recommends that, in order to assure a minimum pledge amount, the pledge requirement be modified to the greater of (i) 5% of deposits not including IBF deposits, (ii) 1% of deposits including IBF deposits, or (iii) $1 million.)[43]

If these changes are effected, the remaining distinctions between branches and agencies under New York law will have been eliminated. Accordingly, unless after surveying existing agencies (which the Committee recommends the Banking

Department do) there were a cogent reason to retain the agency form, the Committee would not see a purpose in continuing to maintain the two names. Agencies would then automatically become branches without further application. It may be, however, that home country laws or laws of U.S. "home states" under the IBA will give agencies continued utility; or it may be that the agency form could be useful in fashioning a solution to the problems under the IBA faced by banks doing business in New York that have acquired or merged with corporations, such as insurance companies, that do not conform to the requirements of Section 4(c) of the Bank Holding Company Act.

**Representative Offices**

Representative offices, unlike other forms of New York presence for foreign banks, do not incur banking liabilities in New York. Therefore, unless they violate the restrictions placed on the types of business that they are permitted to do, they do not require the same type of supervision as other forms of organization which foreign banks use to do business in New York.

Basically, a representative office does business only on behalf of its home office or other authorized branches. Historically, this has been interpreted to mean not only that the representative office (1) not take deposits or make advances and (2) not incur liabilities for deposits or money borrowed but also (3) that its personnel not approve any loans.[44] These concepts relating to loans become somewhat tenuous in an electronic world. The place where a loan is approved or where documents are exchanged is not of particular importance. Non-banking companies freely make loans in New York and both banking and non-banking companies from outside New York



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freely solicit credit card and mortgage business in New York. The essential restrictions which representative offices should have, therefore, are restrictions on taking deposits or incurring banking liabilities. If a bank with a representative office in New York fails, it should be clear to all who dealt with it that they must look outside New York to collect funds due from banking transactions.

Unfortunately, some representative offices have violated the terms of New York's authorization to do business as a representative office by accepting deposits from retail customers for transmission to the head office in a manner not permitted by the Banking Department. In 1990, for example, The National Mortgage Bank of Greece was indicted by a federal grand jury sitting in New York on 30 counts of money laundering and the related failure to file currency transaction reports on approximately $700 million of deposits transmitted to its home office. Prior to the indictment, the National Mortgage Bank agreed to a $2 million settlement with the Federal Reserve Board arising out of the same facts.[45]

The Committee recommends that New York laws regarding representative offices be amended to provide that:

- All representative offices must be licensed by the Banking Department (at present only offices of banks with less than $500 million of assets are required to be licensed).[46]
- The Banking Department has authority to examine and supervise all representative offices.
- Representative offices may engage in loan-related activities that are wholesale in nature as defined

by the Superintendent, provided that they take no deposits or cash for any purpose, advance no cash, and issue no letters of credit or other obligations.

- A representative office is prohibited from soliciting retail deposits. Violation of this provision should be a criminal offense. (Retail deposits for this purpose could be defined as initial deposits of less than $100,000 or deposits in excess of $100,000 by an individual without a related business transaction.)

These recommendations are basically consistent with the bill introduced by the Banking Department in 1991, except that the Committee would place lesser restrictions on the lending activities of representative offices. The Committee recognizes that expanding the type of involvement in the lending process that representative offices can engage in would be a material change. The Committee does not believe, however, that permitting representative offices to play a more forthright role in the lending process will pose significant dangers to the public so long as the deposit-taking and other liability-side rules are strictly enforced.

The Committee considered whether, in order to protect the public, it was necessary to prohibit a representative office from being located on the ground floor of a building or adjacent to a licensed money transmitter. This could be a prophylactic measure to reduce the ability of a representative office to improperly solicit deposits from retail customers who may not understand that the representative office is not a banking office supervised by the Banking Department. The Committee decided that locating a representative office on the



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ground floor or in close proximity to a money transmitter should be permitted only with the prior approval of the Superintendent and recommends that this rule be embodied either in the legislation or in regulations of the Banking Board.[47]

The Banking Department historically has not required a foreign bank to establish a representative office in New York before it may seek a license for a branch/agency. One advantage to this "staging" approach would be that the Banking Department could increase its knowledge of the foreign bank and the foreign bank could increase its knowledge of the New York market and banking regulations, before the foreign bank expands its operations through the establishment of a branch or agency. Although the Committee encourages the staging approach, the Committee believes that the lack of a prior representative office is not sufficient justification for denying a branch or agency license to a foreign bank which, in the opinion of the Superintendent, satisfies the requirements to establish a branch or agency in New York.

In licensing foreign banks to have representative offices in New York, the Committee believes that the Superintendent should emphasize the needs for a reasonable business purpose and plan and a review of the reputation of the bank for sound management and integrity. The Committee believes that it may be appropriate to permit smaller banks and banks from countries with relatively weak banking systems to have a presence in the representative office form. In such cases, however, the Banking Department should, through the examination and supervision process, confirm that appropriate disclosures are being made to potential customers and that the rule against soliciting retail deposits is not being violated.

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New York Article XII Investment Companies

Article XII of the New York Banking Law provides for the establishment of "Investment Companies", a name which derives from the principal function engaged in by the early ancestors of today's Article XII companies. This name can be confusing in light of the enormous development of mutual funds which are federally regulated as "investment companies".[48]

During the approximately 100 years that Article XII companies have been chartered, four basic types have developed: (1) those engaged, prior to the Depression, in the sale of participations in mortgage investments (so called "bond and mortgage companies"); (2) those engaged in wholesale and retail sales financing and factoring; (3) those engaged in wholesale, primarily internationally-oriented banking; and (4) those that serve as holding companies for merchant banks. The category of "banking investment companies" was the focus of the Committee's review. (Bond and mortgage-type Article XII companies no longer exist; the Committee has no recommendations regarding sales financing or holding company Article XII companies, except to note that they have served a useful purpose and today several of the finance companies are among the soundest in the nation.[49] The form is quite flexible and may in future be beneficial to other financial businesses.)

Banking Article XII companies exercise many traditional banking powers and are recognized in the wholesale banking marketplace as banks, but they cannot accept deposits in New York.[50] The Committee believes that it is the acceptance of deposits rather than the ability to lend that requires the full supervision provided by the banking laws. As noted above, many non-banking companies are engaged in almost every facet of lending without coming under bank regulatory strictures.[51]



The Article XII company charter provides a regulated banking format which, because it does not have general deposit-taking powers, can be regulated somewhat differently from ordinary banking corporations.

The reasons some foreign banks have chosen to organize an Article XII company in the United States have been based on home country restrictions on branching abroad, the flexibility of the Article XII form, or tax considerations. In addition, a branch or agency does not suit a consortium organizational structure. For these banks needing an incorporated vehicle, the Article III commercial bank subsidiary may be cumbersome and the power to take deposits may not be important; the relative freedom of the Article XII companies may be attractive to them. Because Article XII companies accept no deposits in New York, they have no reserve requirements, no rigid per customer lending limits, and no deposit insurance. They are required to maintain their own capital and they are examined like banks, because they stand or fall on their own. To date, however, no Article XII company has failed.

An Article XII company is expressly permitted to maintain credit balances "incidental to, or arising out of, the exercise of its lawful powers".[52]

Although an Article XII investment company may exercise all normal bank lending powers, it may not under current law exercise general fiduciary powers nor become a member of the Federal Reserve System. Thus Article XII companies do not have a lender of last resort.[53]

While, as noted above, Article XII companies are not by statute subject to some of the restrictions applicable to banks, both as a matter of supervisory policy and on a case-by-case

basis, the Banking Department has, in certain respects, applied to Article XII companies similar restrictions as are applicable to branches, agencies and commercial banks. The Committee believes that this is appropriate.

Current Banking Department policy permits the incorporation of Article XII companies by foreign banks that want an incorporated presence in the United States but do not want the power to take deposits in New York. The Committee supports the continued availability of this form of organization, believing that lending from outside the deposit insurance system will be beneficial to the U.S. economy.

The Committee sees no unusual dangers from banking-type Article XII companies, provided that (1) their ownership is clear and their owners are responsible and legitimate, (2) transactions with owners and affiliates are regulated in a manner that prevents abuse, (3) they are examined like banks and required to maintain a reasonable level of capital, (4) loan-to-one-borrower and diversification standards are maintained, and (5) the power to create credit balances is not allowed to be used to take deposits in New York. Banking Article XII companies are not within the federal safety net -- and as such they provide an excellent free market source of credit -- but the Banking Department should supervise them like banks, since for many legal and business purposes they have the attributes of banks.

Because the regulatory framework of Article XII companies has evolved with a view to the economic purposes they serve, they can help to attract international financial business to New York.



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The Committee recommends that the Banking Department continue to have authority with respect to Article XII companies to reject any <u>de novo</u> charter (or any change of control) where, in the view of the Banking Department, there is any possibility that the proposed ownership structure could obscure the ultimate ownership or complicate the enforcement of the Banking Department's supervisory process. The Committee is of the view that the Banking Department should object to a change in the organizational structure of an existing Article XII if the Banking Department concludes that the change could lead to potential ownership or enforcement problems.[54] Organizational structures involving intermediate non-operating companies structured as such for tax planning or other reasons typically should not raise the same supervisory concerns.

The Committee also recommends that the name Article XII "investment company" be changed both to avoid confusion with investment companies registered under the Investment Company Act of 1940 as well as to more closely describe their activities. The Committee has considered the following possibilities: "Financial Corporations", "Finance Companies", "Commercial Lending Companies", or "Article XII Companies".

The Committee further recommends that Article XII companies be given the authority, based on specific approval by the Banking Board, to exercise non-depository fiduciary powers on the same basis as Article III banks. This would not violate the theoretical bases on which Article XII companies are chartered.

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# IV

## REGULATION OF OWNERS

Just as evaluation of ownership is important in the decision whether or not to grant a license, review of changes in ownership of licensed entities is necessary to assure that they do not become controlled by criminal or irresponsible elements. Foreign banks which maintain branches, agencies or representative offices in New York are not currently required to obtain approval for changes in control, as subsidiaries chartered under the Banking Law are required to do.[55] Yet it is often a change in ownership which creates the greatest dangers to a banking institution's health. The Committee therefore recommends that, although it may place some burden on foreign banks doing business in New York, banks with offices licensed by the Banking Department should be required to obtain the Superintendent's approval for changes in control unless an acceptable alternate process has been implemented.

To minimize the burden on banks which undergo changes in control, the Committee recommends that banks be permitted to choose whether to seek change in control approval before or after the change in control has occurred. If the bank seeks prior approval for a change of control, it will have the option of not undertaking the change in control if the application is denied. If approval is sought and denied after the change has occurred, the Superintendent would be given power to revoke the bank's license to do business in New York. Change in control approval should be required for mergers or stock transactions which result in a 25% or greater change in effective ownership to a single person, enterprise or group.



There should be two acceptable alternative processes under which a change in control application would not be required. First, approval should not be required in the case of a merger where the survivor already is licensed to do a banking business in New York. Second, a change in control application should not be required in the case of a transaction which has been approved by the bank's home country supervisor under procedures that are acceptable to the Superintendent.

This change in control approval authority should be adopted by statute. The statute should not, however, attempt to completely define what constitutes a change of control for a foreign bank with an unincorporated office in New York. The statute should establish a 25% of voting shares change in control test but should leave further definition to the Banking Board. The Committee's view is that the test, as much as possible, should avoid the type of complex questions which result from federal change of control rules.

New York change of control rules also do not currently make clear that any party that makes application to control a New York banking organization is required to submit to the jurisdiction of the State of New York for purposes of enforcing laws related to the ownership of the bank. This apparent legislative oversight could be remedied by the Superintendent requiring such submission to jurisdiction as a condition of approval. The Committee believes, however, that legislation would be clearer and more appropriate and therefore recommends such legislation.

## V

## OFFSHORE BRANCHES AND RELATED ISSUES

A number of foreign banks that have branches/agencies in New York also have branches licensed in one or more Caribbean locations, such as the Cayman Islands or Nassau, the Bahamas. In practice these offshore branches frequently are run from New York, by the same employees who run the New York office. It is not unusual for the assets of an offshore branch which is run in this manner to exceed those of the New York-licensed office. Although many of the tax and reserve requirement rules that historically have caused business to be booked to the offshore branch are no longer in force, and New York banks and branches of foreign banks located in New York now have the ability to establish "International Banking Facilities" that provide some of the tax and reserve advantages of offshore branches, the offshore offices continue to book a substantial percentage of the business actually transacted in New York.[56] None of these offshore offices have failed or been found to have committed serious illegal conduct, but their supervision nevertheless needs to be evaluated.

Evaluating the laws and regulations that affect these offshore branches that are run from New York also requires consideration of related issues that result from the ordinary operation of modern transnational banking. Two sets of issues whose implications need to be dealt with are:

(1) New York personnel often oversee all U.S., North American or Western Hemisphere operations of a foreign bank. That oversight involves decision-making and review but often it does not involve executing transactions on behalf of other



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offices. The Committee does not believe that the evaluation of this oversight is part of the Banking Department's function in supervising the New York branch. Under the theory of consolidated supervision, a U.S., North American or Western Hemisphere headquarters is supervised by the home country supervisor through its overall review of operations. The Banking Department therefore should cooperate with the home country supervisor by providing assistance where requested to do so, and may review headquarters operations conducted in New York if appropriate as part of this cooperation.

(2) New York personnel typically play an important role in handling a major bank's foreign exchange and interest rate positions. The "book", which typically for internal purposes will be accounted for at the home office, often consists of a set of trading positions that are adjusted throughout the day, with trading authority being passed from Tokyo to London to New York so that trading can continue in each major market and so that the bank's position can be constantly monitored and rebalanced. Foreign exchange transactions executed by New York personnel typically are done for the account of New York, with an offsetting transaction being done with the home office. In the interest rate market, trades frequently are done for the account of a non-New York office even when the New York personnel are running the book. It is necessary to make clear which trading activities are New York office activities for liquidation purposes. The Banking Department may find it appropriate to examine these activities since they do involve execution of transactions by New York personnel regardless of where they are booked.[57]

**New Documentary Test**

The Committee does not believe that there is any inherent wrong in offshore business being conducted in New York, provided it is adequately supervised by the Banking Department. Supervision of non-New York offices by New York personnel raises no significant issues when that supervision does not involve transacting business on behalf of the non-New York office. When business is executed by New York personnel, however, it appears that steps need to be taken to assure that counterparties know at which office the transaction is being booked and to maintain records of the transaction in New York. And when New York personnel are transacting business on behalf of a branch which is subject to secrecy laws, law enforcement issues may arise as well.

The existing laws do not deal clearly with these situations. As a consequence, it is possible that those who deal with New York personnel could be misled.

The legal problem stems from the Banking Law's definition of what transactions are considered liabilities of the New York office for purposes of liquidating a New York branch/agency. That definition provides that any "transaction had with" the New York office may be a claim against the New York office assets.[58] And for some time it has been unclear -- although it has never been tested in a liquidation -- what the status of transactions booked to an offshore branch by New York personnel would be. The drafters of the statute probably assumed that the New York books would reflect transactions had with the New York office. This sort of assumption may have been appropriate in a pre-electronic age, but the statutory language now falls short of the precision needed when trillions



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of dollars of transactions are conducted annually through electronic advices.

The key to eliminating the confusion caused by offshore-booked business being done in New York is a clearer test for when a deposit or other liability transaction is deemed to have been for the account of the New York branch versus when it is deemed to have been booked offshore. In many cases there is no inherent difference in how the transaction is conducted; the employee merely puts it on the books of one office rather than on the books of another. Currently there is no rule that dictates how the distinction should be made for liquidation purposes, although it appears that almost all banks provide an advice to the counterparty which designates at which office the transaction has been booked and therefore whose risk was being taken.

Basically, in a New York office liquidation, liabilities on the books of the New York office should be claims against New York assets, while liabilities booked at other offices should not be allowed as claims against New York assets. Confusion could arise, however, when a customer's or counterparty's confirmation reflected that the transaction was for the account of the New York office, whereas the bank had booked the transaction in another office, or where the advice was ambiguous. The involvement of New York personnel in the transaction also might be relevant under the current law, but the Committee believes that it should not be determinative.

The Committee recommends that it is the advice to the customer or counterparty -- whether written or electronic -- that ultimately should govern where the transaction is deemed booked and therefore whose liability it is in the event of liquidation. That New York personnel executed the transaction

should not be determinative. The place of booking, as reflected in the advice, not the place designated for payment, would govern the question of whether a New York office liability had been created for purposes of the liquidation. (The place designated for payment may have meaning for other legal or business purposes, but in the liquidation of the New York office it would not bear on whether the liability created a claim against New York assets. This rule would eliminate much of the existing potential for ambiguity.) The Committee would further strengthen the "documentary" evidence by adopting a liquidation rule under which the evidence, if genuine, would be conclusive. These rules are explained in more detail in the "Liquidation Issues" section below.

The documentation rules will require further definition in the case of foreign exchange, interest rate and commodities transactions. The place of booking should govern these transactions as well as straight liability transactions, but fashioning documentation that makes the place of booking clear to counterparties and takes account of permitted netting arrangements may be more complex. The Committee recommends that the law empower the Banking Board to define the required documentation and that the Superintendent formulate proposed regulations so that the various concerned constituencies can make their needs and concerns known.[59]

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**Record-Keeping**

A document-based test for New York transactions necessarily implies that documents evidencing the transaction be maintained in New York if the transaction was effected by New York personnel. This would be good banking practice even were there no legal reason to maintain the records in New York. The Committee therefore recommends that the



Superintendent require that records of all banking transactions which New York employees effect should be maintained in New York even if the transaction is booked to another office. These records should show whether or not the transaction created a New York liability and such other information as the Banking Department designates as necessary for proper supervision.

The Committee does not contemplate that the Banking Department's record-keeping requirements would apply to transactions where New York personnel performed only true supervisory, introductory or relationship services.

All records maintained in New York would be subject to subpoena by law enforcement authorities, as they are at present.[60]

**No Retail Deposits**

In keeping with the rules recommended for representative offices, the Committee recommends that it be clarified that retail deposits of U.S. persons, as defined by the Superintendent, cannot be accepted in New York for the account of offshore branches.

**Examination of Offshore Activities**

All banking activities conducted in New York but booked offshore should be subject to examination by the Banking Department in its discretion both to observe whether documentary requirements are being complied with and for supervisory purposes.

## Statutory Requirements

The Committee recommends a statute making clear the Superintendent's power to examine offshore business done in New York and the Superintendent's power to require that records regarding such transactions be maintained in New York. It appears that the Superintendent may have such power under existing law, but statutory clarification would be useful to prevent any entity from impeding the Superintendent's exercise of authority.[61]



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# VI

# EXAMINATION ISSUES

A foreign bank branch/agency in New York often is subjected to examination by its home country auditing firm, a home country internal audit group, its own internal auditor, the Banking Department or the OCC, the FRBNY (and the FDIC if insured), and perhaps a separate outside auditor for U.S. operations. In addition, it may have reporting requirements to or be examined by its home country regulator. Logically, there are too many auditors/examiners. Each has its specific function and reason for being, but the process obviously can be wasteful. The Committee therefore recommends that in general the Banking Department should evaluate the work performed by others and seek not to duplicate that work where it is unnecessary. Continued coordination of examinations, as the Committee understands is planned by the Banking Department and the FRBNY, will be of particular importance now that the Enhancement Act requires annual on-site examinations.[62] The cost of examinations can become a significant competitive issue.

## Professional Staff

The level of knowledge and expertise of examination staff is extremely important to conducting examinations efficiently. Examiners who are unfamiliar with international wholesale banking operations inevitably perform less useful and effective examinations, as well as imposing an unfair burden on management. The Committee recommends that the Banking Department train and maintain a specialized examination staff to examine foreign bank branches/agencies. In light of competition for experienced personnel, attracting and retaining

such staff will require higher salaries than the Banking Department currently is able to pay. The Committee recommends that the Legislature and Executive Branch enable the Banking Department to pay these higher salaries. The cost ultimately will be borne by the examined banks. The alternative is less protection and further erosion of the dual banking system, which already is threatened by the federalization of bank powers and the FDIC's new powers for early intervention and closure of troubled state-chartered banks.

**Reporting Requirements**

Foreign branches and agencies, like domestic banks, are subject to numerous reporting requirements. The Committee did not find that any specific reports should be eliminated but recommends generally that, to the extent possible, where banks have both state and federal reporting or application obligations, the Banking Department should continue to accept reports or applications on the federal form. This is a simple matter of administrative efficiency. And if the Banking Department requires additional information not called for by the federal form, it should be, as it normally is now, a clear addition to the form.

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**Other Supervision Issues**

The Committee sought to identify particular areas of banking, other than traditional asset quality or interest rate or currency risk issues, which could pose threats to the health of a bank or the banking system. Two of these areas warrant comment.

The greatest change in wholesale banking in recent years has been the growth of off-balance-sheet and derivative



transactions. Major foreign and U.S. banks engage actively in these markets both in New York and elsewhere. These transactions, many of which are designed to hedge or speculate in currency and interest rate markets, often result in extremely large notional positions which involve counter-party risks as well as interest rate or currency risk.

The Committee concludes that off-balance-sheet transactions of this nature result in significant dangers mainly when internal controls do not properly evaluate and restrict the risks which traders can assume or permit to continue. There have been a number of cases of banks and investment banks where unauthorized trading or loose supervision have resulted in significant losses. To prevent these situations from arising, the Committee recommends that the Banking Department continue to require each foreign bank branch/agency to maintain appropriate internal controls for off-balance-sheet transactions; in addition, the Banking Department should consider whether the bank's outside auditors should be required to opine on the adequacy of these controls. The Committee notes that similar opinions will be required for FDIC-insured banks under FDICIA.[63]

In the case of New York branches/agencies of foreign banks, supervisory issues may arise when, in order to gain a higher rating for obligations of other parts of an international banking system or to qualify for exemption from securities registration requirements, New York branches guarantee the obligations of other branches or subsidiaries of the same bank.[64] These guarantees, so long as they are genuine guarantees, are liabilities of the New York branch which qualify for the New York asset priority in liquidation.

A second phenomenon that is not apparent from a bank or branch's balance sheet, but can cause systemic problems, arises when a bank or branch frequently has a payment volume that is abnormally large compared with its balance sheet size. For the most part, this issue is protected against by the payments system itself, which, if it operates correctly, will not extend excessive intra-day credit.[65] From a bank supervisory perspective, the Committee believes that this also is basically a controls issue, and recommends that where payment volumes are high in relation to balance sheet size, the Banking Department should assure itself that appropriate controls are in place so that the bank does not overexpose itself on an intra-day basis.

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# VII

## SUPERVISION OF BRANCHES/AGENCIES TO PROTECT NEW YORK CREDITORS

One of the key goals of regulating and supervising branches/agencies of foreign banks is to protect New York creditors of those offices in the event that the bank fails. Although this goal of regulation and supervision of offices of foreign banks is the same as a major goal of regulation and supervision of domestic banks, United States regulatory authorities have little influence or control over whether a foreign bank may fail. United States regulators must rely on home country regulators to prevent or remedy the failure of foreign banks that do business here, and, in the event of failure, the United States role is basically limited to protecting those who dealt with the U.S. office.

Protecting those who deal with New York offices of foreign banks in the event of failure begins with sound liquidation laws, as to which the Committee makes recommendations below. In order to utilize those laws, however, the supervisor has to pursue policies which reasonably assure that the assets of the New York office will be at least equal to the liabilities of the New York office under those rules. Yet to enforce policies on healthy banks which relied primarily on New York assets rather than on the financial strength of the bank as a whole would be cumbersome and would tend to negate the benefits of the branch/agency form. As a consequence, the Committee believes that the Banking Department should implement policies to maintain New York assets only when either the bank or its home country's economy shows signs of weakness that eventually may potentially

threaten the bank's solvency or liquidity. When these signs are present, the Committee believes that the Banking Department should implement a program to (1) promote asset diversification and the holding of New York-based assets, (2) restrict amounts due from home (and other branch) office, (3) protect against set-off or netting against deposits reflected as assets on the branch/agency's books, and (4) impose an asset maintenance program. These steps will not guarantee that all creditors of the New York branch/agency of a failed foreign bank will be paid in full, but they should provide reasonable protection, given the fact that uninsured branches/agencies will have no substantial retail deposits. Moreover, these steps are flexible enough that the Banking Department can use them selectively and to varying degrees to address the variety of problems or potential problems that may arise.

Except when a bank is subject to an asset maintenance program, the Committee does not believe that a branch/agency should be required to maintain its own loan loss reserves. Adequate reserves should be maintained by the bank as a whole, and the Banking Department should seek to satisfy itself that reserves are sufficient. A lack of assurance as to adequacy of reserves on the bank's books may lead the Banking Department to impose some of the measures outlined in the preceding paragraph, which may include establishment of loan loss reserves on the books of the branch/agency.

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**Asset Diversification**

Asset diversification, one of the basic principles of bank management, which is emphasized in the supervision of domestic banks, has not been emphasized in the supervision of foreign bank offices because those offices are not expected to stand on their own. However, where a New York office has a



concentration of assets in the obligations of businesses and government entities from a financially weak home country, the Banking Department should be concerned about that condition and should take steps to redress it. Even a balance sheet that has assets of obligors from several weak countries is preferable to one that has assets from a single such country, since it is less likely that several nations will experience economic crisis at once than that a single one will do so. The Committee would leave the extent of diversification required to practicality and the Banking Department's case-by-case judgment.

As part of this diversification, the Banking Department should encourage the holding of New York and other United States assets, as well as a high level of investment grade liquid assets. In the event of a liquidation, it usually is more difficult to collect loans due from foreign obligors than loans due from United States obligors. In addition, hard assets and liquid assets in the U.S. often provide greater value in a liquidation than do foreign assets.[66]

**Due From Home Office**

Federal branches are limited in the percentage of their assets that can consist of accounts due from head office or, in some cases, other branch offices of the same bank. At the present time this percentage is 50%. The Banking Department restricted this percentage before 1983 but since then has not done so.[67]

The Committee recommends that when a bank or its home country economy exhibits signs of weakness, the Banking Department should limit the percentage of assets of the New York office that may consist of accounts due from the bank's home and other branch offices. By imposing this limitation in

the event of signs of weakness, the Banking Department will be enhancing its ability to provide additional protection if the bank or country weakens further. The Committee believes the Banking Department should continue to have the right to impose such a limitation flexibly based on the needs of a given situation.

**Set-Off and Netting**

One of the major theoretical concerns about protecting creditors of New York branches/agencies is the prevalence of set-off and netting schemes in wholesale markets. Clearing agencies and interbank markets have adopted various forms of netting agreements under which the assets of a New York office could be netted against a liability of the home office or another branch of the same bank or the same clearing group. This mechanism could result in "due from" accounts on the books of a New York branch being illusory (uncollectible) assets in the event of a liquidation. As a consequence, the argument runs, the less sophisticated creditors of the New York branch might not be paid in full, while the sophisticated wholesale bank creditors might be made whole through the netting process.

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The question arises, therefore, whether New York's set-off and netting rules should protect the unsecured creditors of a New York office from the ability of banks to set off New York office deposits against liabilities of non-New York offices. For several reasons, such a set-off prohibition does not appear to be sensible or a viable alternative. First, it would put New York out of step with international trends. It appears that in most countries the laws permit netting arrangements, even where banks do not ordinarily have a right of set-off. Second, as a matter of policy, it appears that netting arrangements serve the payments system well. Without netting arrangements, intra-



day management of risk is less efficient, which leads to potential systemic risk and impedes international commerce. And third, in FDICIA Congress has partially preempted the field by explicitly validating many netting arrangements among financial institutions.[68]

It would be open to New York to validate only explicitly agreed netting arrangements, but this approach would ignore New York's long history of recognizing a banker's right of offset.[69] The need to protect New York creditors does not appear so compelling to the Committee that it should recommend revising this body of law, which would have ramifications beyond the regulation and supervision of transnational banks.

The Committee believes that by requiring weak banks and banks on asset maintenance to enter into agreements with New York depositories which explicitly agree not to net against New York office assets, the Banking Department can protect creditors of banks that are known to have weaknesses. In asset maintenance cases, only deposits in depositories with such non-netting agreements would be considered eligible deposits for asset maintenance purposes. (This in fact was Banking Department policy before 1983, but was terminated when general asset maintenance was repealed.)[70]

The risk that is run by permitting netting and set-off in the case of apparently strong banks is that an apparently strong bank will fail as a result of a catastrophic event. In practice, this very rarely occurs, and the benefits of a wholesale banking system that functions smoothly outweigh, in the Committee's judgment, the relatively remote risk of loss as a consequence. The loss, we would point out in addition, would not be a loss to

retail depositors since uninsured branches/ agencies will have no substantial retail deposits.

**Asset Maintenance**

Asset maintenance has long been among the Banking Department's normal mechanisms for protecting New York creditors. Until 1983 all New York branches/agencies were subject to asset maintenance rules, but asset maintenance for all but a few banks was lifted in that year in order to equalize treatment with federal branches authorized under the IBA which, under the OCC's rules, were not subject to asset maintenance.[71] Today, the Banking Department applies asset maintenance to about 25 banks from countries whose currency or economy are unstable and to a few banks that are experiencing financial weakness. These banks account for less than 1% of the total assets of foreign bank offices in New York.

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Under asset maintenance, the Banking Department adopts a quasi-separate-entity approach to supervising a foreign bank's branch/agency. It takes the liabilities at face value and requires the branch/agency to maintain assets in New York at least equal to a percentage of those liabilities, which usually is set between 105% and 125%. In addition, in computing the assets of the branch/agency, the Banking Department may assign discounts to assets from weak countries or assets of doubtful collectability, sometimes requiring that assets be counted at as little as 20% of face value.[72] For banks on asset maintenance in New York, the Banking Department also gives no asset credit for accounts due from the bank's home office or other branch or affiliate offices.

Asset maintenance has the potential to protect New York branch/agency creditors if the assets are properly valued



on the balance sheet. In many cases, however, the Committee recognizes that this may not be the case. For example, if most of the credits are home-country based, home country political or economic upheaval may render them uncollectible. For this reason, the Committee recommends the diversification goals discussed above and loan loss reserves where appropriate.

In some cases, it may be tempting for banks in difficulty to engage in transactions which are beneficial to home country offices but not to U.S. offices. The Banking Department therefore should require that all branches/agencies subject to asset maintenance conduct all transactions with affiliates at arm's length for equivalent value or with Banking Department approval. Violations of this rule should be personal violations by managers who knowingly participate in the violations as well as corporate violations. These rules apply to affiliates of incorporated subsidiaries, and when, under asset maintenance, a branch/agency is treated as a quasi-incorporated entity, it is appropriate to impose such rules on that entity. In addition, the Banking Department should be alert to prevent other means of circumventing asset maintenance requirements.

The Committee is aware that sometimes when a weak bank is first made subject to asset maintenance, it is not possible for the Banking Department to obtain sufficient assets in New York. The Banking Department's present policy of seeking assets rather than precipitously terminating licenses when difficulties arise appears appropriate. The Banking Department can, of course, pick up early signs of a bank's weakness by watching its liquidity and its access to wholesale markets. Often a bank's wholesale lines of credit are reduced well before its problems are revealed as balance sheet weakness.

# VIII

## LICENSE TERMINATION

The Banking Department has a number of flexible tools that it can use to attempt to remedy problems that it perceives at New York-licensed offices of foreign banks. These range from informal pressure, through cease and desist orders, to the ultimate sanctions of license revocation and taking possession.[73] The Committee does not believe that additional tools are required but does believe that the standards for license revocation should be redefined and that supervision of a bank whose license has been revoked should be clarified.

Under the Enhancement Act, the Federal Reserve Board has been given power to terminate the license of a state-licensed office of a foreign bank if either (1) the foreign bank is not "subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country" or (2) "there is reasonable cause to believe" that the foreign bank has "committed a violation of law or engaged in an unsafe or unsound banking practice in the United States" as a result of which continued operation in the U.S. "would not be consistent with the public interest".[74] The law directs that any foreign bank that is required to terminate activities in the U.S. shall comply with "applicable Federal and State law" with respect to procedures for closure or dissolution.[75]

The Banking Law standards for license revocation are the same as the Banking Law standards for taking possession of a branch/agency of a foreign bank.[76] They include violations of law, conducting business in an unauthorized or unsafe manner, being in an unsound or unsafe condition to transact



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business, having neglected or refused to comply with an order of the Superintendent, or having refused to provide information as required. These grounds thus include, in somewhat different language, the grounds for license revocation granted to the Federal Reserve Board, except for the home country supervision standard. The Committee does not recommend that any statutory grounds be added but, believing in general that if entry standards are no longer met by a bank the Superintendent should have power to terminate its license, the Committee recommends that the statute permit the Banking Board by regulation to designate some entry standards which, if no longer met, would be grounds for license revocation.

In addition, the Committee recommends that new safeguards be enacted to require that a hearing be held before license revocation. Such a hearing should not stay other enforcement measures, but due process standards should be observed before revoking a license to do business.

More urgent than changing the standards for license revocation is the necessity to provide a clear mechanism for winding up the affairs of a New York branch/agency whose license has been terminated either by the Federal Reserve Board or the Superintendent. As noted above, the federal law only directs the terminated licensee to comply with federal and state laws but does not provide a mechanism for winding up the business. Current New York law is also deficient in that it provides for no supervision of a liquidation following a license revocation. The Committee therefore recommends that the Banking Law empower the Superintendent to supervise the withdrawal of a bank whose license to do business has been terminated. Such supervision should include the continuing right to issue orders, examine and require and receive such reports as the Superintendent deems necessary. The

Superintendent also should have the continuing right to take possession under the existing statutory grounds.[77]



# IX

## LIQUIDATION ISSUES

As reflected in several areas of this Report, many of the supervisory issues that arise with respect to branches and agencies look to the liquidation rules to protect creditors of the New York branch/agency. This protection depends upon four principal issues:

- The definition of liabilities for which the New York office is responsible.
- The definition of assets which the New York office can utilize to satisfy those liabilities.
- The relative priority of New York office creditors with respect to those assets.
- The procedural ability of the Superintendent to effect an orderly liquidation of the assets and payment of the liabilities.

### Priority Status

Historically, New York has given priority status to creditors of the New York office.[78] The Committee believes that this priority for creditors of a New York branch/agency is appropriate because it provides the best means for New York regulators to protect those who deal with the New York office.



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After New York claimants have been paid, New York law directs the Superintendent to deliver excess assets to the home country liquidator as part of the overall liquidation of the bank.[79] The alternative formulation is that the assets could be utilized to provide first for the protection of creditors of other branches/agencies in other U.S. jurisdictions.

Under the IBA a foreign bank which has a federal branch is deemed to have all of its U.S. branches/agencies liquidated as one.[80] That law would take precedence over the New York law if there were both a federal branch and a New York branch, but it also suggests a U.S. policy that creditors of U.S. offices should be given priority as against other creditors of a failed foreign bank. The Committee believes that this rule is a suitable precedent for the adoption of a statute in New York under which excess assets in a New York liquidation would be made available to liquidators of a branch/agency of the same bank in other U.S. jurisdictions. This rule would apply where a failed foreign bank had branches/agencies licensed by another state but no federal branch/agency.

California has such a rule, which applies only in cases where other states have enacted reciprocal laws.[81] That is, under the California rule excess assets are utilized to pay creditors of other state-licensed offices only in states which reciprocate with California. The Committee believes that New York should adopt a statute similar to California's so as to encourage this type of reciprocity.

If assets remain after creditors in states with reciprocal laws have been paid in full, then the law should provide for sharing with states that do not have reciprocal laws.



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The last significant question on this issue is the manner of apportionment of excess assets among potential claimants from each of the categories of other U.S. jurisdictions. The Committee recommends that the law provide that the Superintendent shall make excess assets available in proportion to the amount of shortfall in other jurisdictions. Any excess above such shortfalls would be made available to the home country liquidator.

## Definition of New York Creditors

The Banking Law grants the New York preference to "the claims of creditors of such [foreign bank] arising out of transactions had by them with its New York" branch/agency.[82] As discussed above, New York personnel frequently participate in transactions which are booked by other offices of foreign banks, which practice, in the event of liquidation, would be likely to lead to litigation by persons claiming a right to priority in New York assets regardless of the fact that the transaction was booked to a non-New York office of the bank. This potential confusion is enlarged by the practice of some banks to issue confirmations that show a deposit made to the "XYZ" branch which is "payable" in or through New York. The current law is unclear as to whether such a depositor would have a right to make a claim in the liquidation of a New York office. As discussed above, this situation also causes confusion in the examination process because examiners cannot ascertain with certainty what the liabilities of the New York branch/agency may be and therefore whether or not the books are accurate.

The Committee recommends that this ambiguity be remedied by a statutory amendment that clarifies when a transaction, regardless of the participation of New York personnel, does or does not create a New York office

obligation. The statute would begin with a presumption that the books of the New York office reflected all liabilities; it would then provide that this presumption could be rebutted by showing an advice that created a New York contractual liability. This test will permit all parties to know with reasonable certainty whether or not an obligation of the New York office has been created.

The statutory amendment should be explicit that (1) an advice (electronic or paper) must be provided promptly by New York personnel with respect to every transaction creating a liability which is effected by New York personnel; (2) the advice must state the office for whose account the transaction is performed; (3) the advice may state that funds are payable at a different place, but the place of payment does not govern whether the liability is a New York office liability in liquidation;[83] and (4) an advice that complies with these requirements is conclusive so long as it is genuine and not clearly a mistake, was promptly sent to the proper party by or on behalf of the New York office, and was not promptly objected to as erroneous. An ambiguous advice would not overcome the presumption that the books are correct. The Banking Board should be empowered to promulgate regulations to give further content to this statutory scheme, because the Committee perceives that many technical issues will have to be resolved. These should be left to the Banking Board, which can adjust to technological developments more quickly than a legislative body.

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When these changes in the definition of the liabilities of a New York office are made, the Committee recommends that the definition of liabilities for asset maintenance purposes (defined in Banking Law Section 202-b) be made congruent so



that assets will be maintained against the same liabilities that would be recognized in a liquidation.

At the same time, the law should be clarified so that claims of banks or corporations under common control with the failed bank will not be deemed obligations of the New York office in liquidation.

As described above, foreign exchange, interest rate and commodities transactions raise special issues. The statute should provide a presumption that these transactions are the responsibility of the branch at which they are booked but should empower the Banking Board to promulgate regulations that define the documentary requirements for establishing conclusively whether or not the transaction was a New York office transaction for liquidation purposes.

Tort or fraud claims cannot be dealt with by this mechanism. Damage caused by New York personnel acting on behalf of the failed New York office would have to be a claim against the New York office liquidation. Other tort claims against a failed foreign bank would not be claims against the New York office in liquidation.

New York Assets

The Banking Law defines the assets of a branch/agency of a foreign bank which has been taken over by the Superintendent quite expansively. Those assets include "all property of the foreign [bank]... (1) Wherever situated, constituting part of the business of the New York agency or branch and appearing on its books as such, and (2) situated within this state whether or not constituting part of the business of the New York agency or branch or so appearing on its

books."[84] This expansive definition has enabled the Superintendent to seize deposits and other assets of a failed foreign bank which were present in New York because of New York's position as an international banking center rather than because they were related to the business of the New York branch/agency.

The Committee does not recommend any change in the current statutory definition of New York assets. Although that definition may lack formal elegance, it is very practical. When a bank with offices in many countries fails, a variety of liquidators seek to possess assets present in their jurisdiction. In most cases; the worldwide assets will not be sufficient to pay worldwide creditors. There is thus no guarantee that if New York limited its claims, the logic of its position would be followed in other jurisdictions. Unless and until an acceptable international mechanism for liquidating failed banks is established, New York's practical statutory definition of New York assets is appropriate.

**Powers of the Superintendent**

Because of the many liquidations of domestic banks, a large body of law, both statutory and judge-made, has developed which enlarges the FDIC's powers as receiver of a failed bank. The powers of the Superintendent as liquidator are, by contrast, generally stated in the Banking Law, subject to court supervision, and are not the subject of a large body of case-law.[85] The Committee has not found that the Superintendent is severely hampered as a liquidator but does have some recommendations for expanded powers.



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D'Oench Duhme Rule

One problem that vexes all liquidators is defenses to claims by the liquidator which are based on agreements or understandings not reflected in the files of the organization being liquidated. The FDIC has solved this problem by both case law and statute. (Federal Deposit Insurance Act ("FDIA") Section 13(e) and the D'Oench Duhme rule.)[86] This body of law enables the FDIC to reject allegations based on oral agreements, courses of conduct or documents that were not part of the records of the failed bank. The Committee believes that the efficiencies enabled by the D'Oench Duhme rule outweigh the occasional injustice that may result from its application.[87] Litigation costs are a material issue in bank liquidations and these rules reduce those costs and provide a greater level of certainty and a reduction in the time the liquidation takes. The Committee therefore recommends that the Banking Department propose and the Legislature enact a statute which codifies a part of the D'Oench Duhme rule and applies it to liquidations of New York branches/agencies of foreign banks. This statute should clearly show that the rule is a procedural one that applies to claims against the New York office in liquidation rather than a substantive one that is intended to govern the transactions for other purposes. The Committee does not recommend that FDIA Section 13(e) be incorporated into New York law because that section contains burdensome requirements that interfere with normal commerce and are not necessary to protect the Superintendent as liquidator.

Executory Contracts

The FDIC has explicit statutory power to repudiate executory contracts of failed banks.[88] This power enables the FDIC to repudiate real estate leases, data processing contracts, employment agreements, and other service contracts without penalty. The Superintendent has exercised similar powers

under the Banking Law but the powers are not explicit. The Committee recommends that the Superintendent, as liquidator, should have the statutory power to repudiate executory contracts for goods, services or real property, with no penalty for future obligations. Letters of credit, futures contracts and other financial contracts may require different treatment.

Qualified Financial Contracts

Executory financial contracts, including futures, forward, swap and similar contracts (but not including agreements or commitments to lend), present more complex issues. These contracts are entered into typically to hedge or speculate in interest rate, currency or commodities markets, and often more than one obligation is involved in a single transaction. In addition, such transactions often will exceed, in notional amounts, the actual balance sheet footings of a branch several times over. The handling of these contracts therefore can be crucial to the outcome of a liquidation; even more important, their handling could have an important impact on the stability of the financial markets affected.

The Committee believes that certainty is the most important goal of the law in such cases. When a branch or agency fails, those who have dealt with it in the financial markets need to know quickly and with certainty whether their transactions will be performed or whether they should seek cover elsewhere. They need to know also whether collateral, if any, will be released. The liquidator should not have an option of whether or not to affirm the transaction or an option to choose to honor one part of the transaction and not another.

Recent amendments to the FDIA have created a category of contracts denominated "qualified financial contracts", which comprise substantially all futures, forward,



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swap and similar contracts.[89] With respect to qualified financial contracts ("QFCs"), the FDIC's powers are more restricted than they are with respect to executory contracts generally. The FDIC cannot prevent a counterparty from terminating a QFC if the documents provide a right of termination on the appointment of a receiver. This allows the counterparty to terminate and cover; with damages being explicitly limited to the costs of cover. Different treatment is provided, however, if either the documents do not provide a right of termination or the counterparty does not terminate or if the FDIC arranges for another bank to take over the transaction as part of a sale of the failed bank. In these cases, the FDIC has an effective option to affirm the contract.

These rules that apply to FDIC liquidations are more complex than those required for liquidations of foreign bank branches/agencies. The Committee recommends that the Banking Law provide that all QFCs (adopting the definition contained in the FDIA), to the extent that they remain executory in nature, which are obligations of the failed branch/agency, shall, for purposes of the New York liquidation, be deemed terminated on the date that the Superintendent takes possession, with damages to be assessed against either party based on the state of the market on that date. Collateral held by either party, except to the extent of damages computed as of the date of possession or a conflict of positions among liquidators, should immediately be released.

In practice, this rule is likely to have the same results as the FDIA rule, since the Superintendent conducts liquidations rather than doing whole bank sales, and since in practice documents do provide for a right to terminate QFCs on the appointment of a receiver or liquidator. The Committee

believes that adopting the FDIA rule would leave more uncertainty in the marketplace than is warranted.

The term "obligations of the failed branch/agency" used above requires further definition, since executory financial contracts involve both obligations and assets, and it is recognized that the basic rules governing assets and liabilities are, as explained above, different. The Committee believes that in the case of executory QFCs the liability side should govern whether the related asset side is an asset of the receivership. In other words, if the obligation is an obligation that is enforceable against the branch/agency, then the asset is deemed to be an asset of the branch/agency regardless of whether it would be an asset of the branch/agency under the normal asset test. Conversely, if the liability is not a liability of the branch/agency, then the asset also should not be such even if it would have been an asset of the branch/agency under normal rules.

These rules cannot absolutely preclude a home country liquidator from asserting that under the home country law the liquidator has the option to affirm the transaction or that the transaction terminates on a different date; and it is recognized that such a possibility would detract from the certainty which this formulation seeks to achieve. The Committee believes, however, that it is preferable to assert, for New York liquidation purposes, that New York law governs the transaction and its termination rather than leaving the matter to a home country law that may be unclear or that may be detrimental to the Superintendent's ability to liquidate efficiently or the interests of parties that dealt with the New York branch/agency.



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Letters of Credit and Commitments

The FDIA has no special provisions regarding commitments to make loans or letters of credit. Accordingly, under its general power to disaffirm contracts, the FDIC is free to repudiate such obligations, and the receivership is only liable for past damages. The FDIC interprets this rule to mean that, except for fees paid and other out-of-pocket costs, no damage has occurred unless a draw was demanded prior to the receivership date.

The Committee believes that letters of credit should be specially treated under the Banking Law. Parties who accepted a bank's letter of credit may be damaged by the bank's failure and the repudiation of the letter of credit even if no condition under which the letter of credit could have been drawn upon existed prior to the date the Superintendent took possession. The Committee recommends, therefore, that while the Superintendent should have power to repudiate letter of credit transactions, the damages should not be fixed at the date of taking possession. Instead, the law should presume that it may take some period of time to replace the letter of credit and therefore damages occurring as a result of a drawdown event up to three months after the date of taking possession should be a claim against the estate unless the event was caused by the bank's insolvency or failure to extend or renew the letter of credit. The Committee believes that a beneficiary of a letter of credit written by a New York branch/agency of a foreign bank is within the category of persons who dealt with the New York office that the law should seek to protect. Any claim should, however, be limited to the amount of the draw.

The Committee does not believe that loan commitments require this special treatment. Although a letter of credit is for

some purposes a commitment to lend, it carries with it also the known reliance by a third party. Loan commitments do not carry this explicit third party reliance, and therefore the Committee believes that they should be treated as ordinary executory contracts which can be disaffirmed, with damages accruing only to the date of disaffirmance.

## **Federal/State Issues**

As noted above, under federal law, the OCC, as liquidator of a federal branch, is given power to seize all U.S. assets of a failed foreign bank that has a federal branch.[90] This would defeat the New York system for liquidating a branch/agency if the failed foreign bank had a New York branch/agency as well as a federal one. The Committee believes that the states and the OCC should attempt to work out these differences, preferably by recommending an amendment to the IBA that would eliminate the conflict between state and federal law.

The ability of home country liquidators to claim New York assets by seeking the aid of federal bankruptcy courts has delayed the BCCI liquidation.[91] The Superintendent has achieved a satisfactory result in this action, and the liquidation now can proceed.[92] It would be useful, however, if federal statute specifically recognized that liquidation of state-licensed branches/agencies, in the absence of federal branches/agencies, should proceed under state law and that the Federal Bankruptcy Act is inapplicable.



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## **Procedural Issues Under New York Law**

### Single Judge

New York law does not now provide for the appointment of a single judge to have plenary power over the liquidation proceedings of a branch or agency being liquidated by the Superintendent. In practice, the Superintendent may be successful in obtaining appointment of a single judge, but the statute should be clear that the Superintendent is entitled to the appointment of a single judge who would have power to hear all New York proceedings to which the Superintendent as liquidator is a party. This mechanism saves both time and legal fees.

### Compromise of Claims

The statute now permits the Superintendent to compromise claims, but only up to $250.[93] This level no longer makes for an efficient process. The Committee recommends that the level be increased to $25,000. This will permit greater efficiency without significant risk to the public.

### Responses to Claims

The statute now requires the Superintendent to evaluate claims within 30 days of the final filing date.[94] Since most claims are filed at the end of the filing period, the practical amount of time that the Superintendent has is 30 days. This period is not long enough to evaluate numerous complex claims, which leads to many claims being denied strictly so that the timetable is complied with. It appears that this leads to premature litigation posturing, which might be avoided if the Superintendent were afforded more time. The Committee therefore recommends that the statute be amended to provide that claims must be accepted or rejected within 60 days rather than the current 30 days.

<u>Automatic Stay</u>

Unlike the Bankruptcy Law, New York law does not provide for an automatic stay of pending litigation against the branch/agency in liquidation.[95] Such a stay would be useful to the orderly conduct of the liquidation in that it would help to force litigants to first go through the claims procedure. This would save legal fees and time. Therefore, although the Committee recognizes that New York State law may not mandatorily stay federal proceedings, the Committee recommends that an automatic stay provision be added to the statute to enhance the orderly processing of claims.

<u>Approval of Contracts</u>

The liquidation of BCCI has been impeded by the necessity for the Superintendent to obtain approval from the State Comptroller for contracts that the Superintendent enters into as liquidator.[96] This approval requirement is not appropriate because (1) the funds being committed are not State funds but only receivership funds, and (2) no funds can be paid out of the receivership without court approval, thus providing a check on the Superintendent's power, if one is thought necessary. In some cases, the Comptroller's approval has taken several months. As a major commercial jurisdiction, New York needs to be able to carry out its liquidation functions efficiently and expeditiously. The Committee recommends that the Superintendent be empowered to commit receivership funds without approval from other government agencies, subject to the continuation of court supervision.



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## X

## BANKING DEPARTMENT FUNDING

As should be clear from this Report, the New York State Banking Department regulates and supervises a very substantial part of the transnational banking business done in the United States. And in the course of this regulation and supervision, the Banking Department has to play an international role in which it is measured not against the performance of other American states but against the performance of central banks and other agencies of sovereign nations.

The costs of international bank supervision are increasing both because there is more international business and because of technological complexity. The Banking Department must be able to incur these costs if it is to remain a respected international regulator. It cannot retain its effectiveness and its international respect if its examiners or supervisory personnel are paid significantly less than those who work for the FDIC, the FRBNY, and the OCC.

The Banking Department's presence as a significant supervisor is important to New York because the Banking Department acts in <u>New York's</u> best interests. Federal regulators also protect New York's interests, but more incidentally.

The Banking Department ultimately is funded by the banks and other organizations it supervises, not by the New York State Treasury. Although the Banking Department receives funds from general state appropriations, the fees and assessments collected by the department from banking

institutions which it supervises have always been sufficient to support the Department's activities. It is therefore possible as well as necessary for the Banking Department to have an independent budget. The Committee believes that budgetary independence is crucial, not just desirable but crucial, if the Banking Department is to continue to play a meaningful international role.



**Notes**

1. 12 U.S.C. § 3101 et seq.
2. 12 U.S.C. § 3105(b).
3. P.L. 102-242.
4. Statistics regarding foreign banks doing business in New York are derived from the records of the New York State Banking Department.
5. Statistics regarding business done by foreign banks in the United States are derived from information furnished by the Institute for International Bankers.
6. See Ingo Walter and Anthony Saunders, National and Global Competitiveness of New York as a Financial Center, New York University, Salomon Center Occasional Papers in Business and Finance 1991-11.
7. This position is reflected in FDICIA § 215.
8. Intra Bank, S.A.; Banco de Intercambio Regional, S.A.; Bank of Credit and Commerce International S.A.
9. BCCI maintained a New York agency. The Banking Department effectively ordered that agency to cease operations in March 1991 and was overseeing an orderly exit when BCCI failed on July 5, 1991.
10. FDICIA § 215.



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11. Second Council Directive of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 32 O.J. EUR. COMM. (No. L 386) (1989) (Council of Europe).

12. Bank for International Settlements, Committee on Banking Regulations and Supervisory Practices, Principles for the Supervision of Banks' Foreign Establishments (Basle, May 1983).

13. Bank for International Settlements, Basle Committee on Banking Supervision, SUPPLEMENT TO THE CONCORDAT (The Ensuring of Adequate Information Flows Between Banking Supervisory Authorities), published as attached to Information Flows Between Banking Supervisory Authorities (Basle, April 1990).

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14. The Banking Department is an observer on the Interagency Country Exposure Review Committee ("ICERC") as a representative of the states.

15. See FDICIA § 203.

16. See Banking Law § 26. The Banking Board is a governmental body appointed by the Governor. It consists of banker representatives, public members and the Superintendent, who is its chairperson. The Banking Board has formal authority to adopt regulations and to approve charters and many types of



licenses. The Superintendent also is the Chief Executive of the Banking Department, which acts through the Superintendent and his or her appointed deputies.

17. FDICIA § 202(a), amending IBA § 7(d)(2), 12 U.S.C. § 3105(d)(3).

18. FDICIA § 202(a), amending IBA §7(d)(3), 12 U.S.C. § 3105(d)(3).

19. Federal Reserve Act §§ 23A and 23B, 12 U.S.C. § 371c et seq. for examples of regulation of transactions with affiliates.

20. The last significant European banks to fail were Herstatt and Ambrosiano. These were significant banks, but were not among their countries' largest.

21. Banking Law § 36(10). See FDICIA § 206, amending IBA by adding a new § 15, 12 U.S.C. § 3105(j).

22. FDICIA § 214(b), by creating a new IBA § 7(j) of the IBA, 12 U.S.C. § 3105(j).

23. The grounds under which the Superintendent may take possession of a banking institution do not specifically include a failure to maintain adequate capital. Historically, however, the power to take possession when a bank is in an unsafe and unsound condition has been interpreted to include a capital level which is unsafe. Insolvency has not been required. No bank has contested this exercise of the Superintendent's power.

24. See, e.g., Foreign Sovereign Immunities Act of 1976, 28 U.S.C. §§ 1330 et seq.; Patrikas, "Foreign Central Bank Property: Immunity From Attachment in the United States", 1982 U. Ill. L. Rev. 265.

25. Bank Secrecy Act of 1970, P.L. 91-508.

26. FDICIA § 202(a), amending IBA § 7 by inserting a new § 7(d)(3)(C), 12 U.S.C. § 3105(d)(3)(C).

27. See Banking Law § 202-b.

28. Banking Law §§ 221-a, 221-b.

29. S.3820; A.7145-A.

30. FDICIA § 204, amending § 10 of the IBA § 10, 12 U.S.C. § 3107.

31. For a branch or agency, see generally Banking Law Article V; a representative office, Banking Law Article V-B; a subsidiary bank or trust company, Banking Law Article XII.

32. See IBA § 6, 12 U.S.C. § 3104; 12 U.S.C. § 1815(b)(c); 12 C.F.R. § 346, Subpart B.

33. See FDICIA § 202, amending IBA § 7 by adding a new paragraph (h).

34. See Banking Law §§ 103, 202-f.

35. Cf. FDICIA § 202, adding IBA § 7(h)(2), and Banking Law §§ 103, 202-f.



36. "Retail" deposits were not statutorily defined prior to the Enhancement Act.

37. See FDICIA § 214(a), amending IBA § 6, 12 U.S.C. § 3104 by adding a new subsection (c).

38. See 137 Cong. Rec. S.18812 (daily ed. December 19, 1991), statement of Senator Garn.

39. See Board of Governors of the Federal Reserve System, SR 91-31, dated December 19, 1991.

40. See Title 3 NYCRR, Part 81 (1981).

41. See Banking Law § 202-a(1)(c).

42. See generally Banking Law § 202-b(1)(a); Title 3 NYCRR, Parts 51, 322 (1981).

43. See Banking Law §§ 202-b(1), 202-b(2), 204; Title 3 NYCRR, Part 322.1(c) (1981).

44. See generally Banking Law, Article V-B and Title 3 NYCRR, Supervisory Procedure CB 121.2(a) (1974).

45. See Money Laundering Alert vol. 1, No. 7, April, 1990, p. 2); BNA Banking Report vol. 53, No. 15, October 16, 1989, p. 535.

46. See Banking Law §§ 221-a, 221-b.

47. See Banking Law § 641.

48. See generally 15 U.S.C. § 80a et seq.



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49. For example, these non-banking Article XII companies include The C.I.T. Group/Equipment Financing, Inc.; General Electric Capital Corporation; General Motors Acceptance Corporation.

50. See Banking Law §§ 508, 509.

51. For example, many finance companies and leasing companies are important lenders in the commercial and consumer credit markets, providing the same types of loans and extensions of credit as banks do.

52. See generally Banking Law, § 508.

53. The Federal Reserve was generally known as the "lender of the last resort" for banks which are members of the Federal Reserve System. FDICIA has limited the Federal Reserve's use of the discount window (see generally FDICIA, § 142 (a)-(c)).

54. The Banking Department may implicitly have such authority pursuant to several provisions in the Banking Law. See, e.g., Banking Law § 519.

55. See Banking Law §§ 142, 143-b.

56. Federal Reserve Regulation D, 12 C.F.R. § 204.8(d) (1990).

57. Banking Law § 200.

58. Banking Law §§ 605(11)(C), 606(4)(a).

59. See, e.g., Banking Law, § 14(1). The Banking Board already has broad authority to adopt rules and



regulations it deems advisable, although the law, as currently drafted, does not specifically refer to "documentation rules" as contemplated by the Committee.

60. See, e.g., N.Y. CPLR §§ 3102, 2111 and R.3120; N.Y. CPL §§ 610.10, 610.20.

61. Banking Law § 36(4) gives the Superintendent broad authority to examine every branch or agency located in the State of New York. In addition, Banking Law § 36(6) grants the Superintendent the authority to examine "corporations affiliated" with a banking corporation, which arguably would include offshore entities.

62. FDICIA § 203(a)(1), by amending IBA § 7(c) to add a new paragraph (1)(C).

63. FDICIA § 112.

64. See, e.g., Standard & Poor's CreditWeek which demonstrates the frequency with which foreign banks guarantee the obligations of their bank and non-bank affiliates.

65. See, e.g., Federal Reserve Board's Interim Policy Statement on Reducing Risks on Large-Dollar Systems, 3 F.R.R.S. 9-1000.

66. In the liquidation of the New York branch of Intra Bank, the major asset that resulted in a full recovery for New York claimants was an office building on Fifth Avenue.

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67. See Letter of Superintendent of Banks, August 2, 1983 (discussing the revision of the Banking Board's Regulation Part 52 requiring asset maintenance with the accompanying revised Part 52 attached).

68. FDICIA, §§ 401-07.

69. See, e.g., Marine Midland Bank - New York v. Graybar Electric Co., 41 N.Y.2d 703, 363 N.E.2d 1139, 395 N.Y.S.2d 403 (1977); Sandler v. United Industrial Bank, 23 A.D.2d 567, 256 N.Y.S.2d 442 (1965); Kress v. Central Trust Co., 246 A.D. 76, 283 N.Y.S. 467 (1935), aff'd, 272 N.Y. 629, 5 N.E. 2d 365 (1936); Miles v. Bank of Commerce, 76 Misc. 2d 623, 351 N.Y.S.2d 513 (1973); Jefferson County Nat. Bank v. Dusckas, 166 Misc. 720, 2 N.Y.S.2d 336 (1938).

70. See Letters of Superintendent of Banks, November 3, 1983, and February 17, 1984 (dropping the requirement that demand deposits with banking institutions in the United States be covered by a waiver of set-off and account designation agreements in order to constitute "eligible assets").

71. 12 C.F.R. Part 28.

72. See Banking Law § 202-b(2).

73. See Banking Law §§ 39, 40, 606.

74. FDICIA § 202(a), amending IBA § 7, 12 U.S.C. § 3105 by adding a new paragraph (e)(1).

75. FDICIA § 202(a), amending IBA § 7, 12 U.S.C. § 3105 by adding a new paragraph (e)(4).



76. Banking Law § 40.

77. Banking Law § 606.

78. Banking Law § 606, Subd. 4(a).

79. Banking Law § 606, Subd. 4(b).

80. 12 U.S.C. § 3102(j).

81. California Financial Code § 1785(d).

82. Banking Law § 606, Subd. 4(a).

83. The law has always contained certain inconsistencies with regard to the status of branches. For example, for purposes of determining the time and location for giving notices in the check collection process, branches are treated as separate banks (see UCC § 4-106), but a bank's ultimate solvency is determined on a consolidated basis. Similarly, service of process and certain other legal actions against New York branches are generally thought not to reach the bank's non-U.S. branches. Thus, no difficulty should arise from providing that a bank deposit may constitute a liability of the New York branch even though it was payable elsewhere, or vice versa.

84. Banking Law § 606, Subd. 4(c).

85. See generally 12 U.S.C. § 1821; Banking Law §§ 606-633.

86. 12 U.S.C. § 1823(e); see generally D'Oench, Duhme and Co. v. FDIC, 315 U.S. 447 (1942), and Langley v. FDIC, 484 U.S. 86 (1987).

87. For a recent discussion of the advantages and disadvantages of the D'Oench doctrine, see Stillman, "Enforcing Agreements with Failed Depository Institutions: A Battle with the FDIC/RTC Superpowers," 47 Business Lawyer 99, 100-113 (1991).

88. 12 U.S.C. § 1821(e).

89. See 12 U.S.C. § 1821(e)(8).

90. 12 U.S.C. § 3102(j).

91. In re Petition of Brian Smouha, Jacques Delvaux and Constant Franssens, Commissaires of BCCI Holdings (Luxembourg), S.A., Case No. 91-B-13569, Jointly Administered, U.S. Bankruptcy Court, Southern District of New York.

92. United States of America v. BCCI Holdings (Luxembourg), S.A., Bank of Credit and Commerce International S.A., Bank of Credit and Commerce International (Overseas) Limited, International Credit and Investment Company (Overseas) Limited, Criminal No. 91-0655, United States District Court for the District of Columbia; Order of Forfeiture entered January 22, 1992 by Joyce Hens Green, United States District Judge.



93. Banking Law § 618.

94. Banking Law § 623.

95. For the Federal provision, see 11 U.S.C. § 362.

96. The New York Comptroller so interprets State Finance Law § 112.



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AMI-ADD-208

# SUMMARY OF RECOMMENDATIONS

## GENERAL RECOMMENDATIONS

The U.S. regulatory system should permit foreign banks engaged in wholesale banking to continue to do business in the branch/agency form rather than requiring that they establish subsidiaries.

Home and host country supervisors of transnational banks should exchange information more systematically in order to better coordinate their supervision.

The New York State Banking Department should continue to play an important role as a regulator and supervisor of transnational banks.

States which license significant numbers of offices of foreign banks, the Office of the Comptroller of the Currency, and the Federal Reserve System should coordinate their efforts to achieve efficiency as well as sound regulation.

The Conference of State Bank Supervisors should coordinate the activities of the states which have significant numbers of offices of foreign banks.

## CRITERIA FOR ENTRY

The criteria for entry that New York currently uses are basically appropriate. In addition, the Superintendent should require consolidated and comprehensive supervision by a responsible home country regulator who should commit to cooperate with New York authorities.

"Consolidated" supervision should include supervision of all branches, wherever located, of all bank investments, including subsidiaries, wherever located, but not necessarily supervision of companies which control banks

or are under common control with them. Home country supervision of a holding company should be required if it is necessary to provide consolidated supervision of a banking group or if transactions between a supervised bank and its holding company or affiliates are not regulated.

"Comprehensive" supervision should require that the home country supervisor have processes and procedures that are designed reasonably to assure that the supervisor know the bank's financial condition, including capital position and asset quality, and the bank's management capability on a current basis.

New York should enact a statute to accord other regulators' confidential documents the same degree of confidentiality as documents generated by the Banking Department.

The Banking Department should make its reports on foreign bank offices available to home country supervisors on a confidential basis.

Encourage home country regulators to provide information to the Banking Department on a confidential basis.

The Banking Department should supplement information from home country supervisors by continuing and expanding its use of banking sources as a means of monitoring the financial strength of foreign banks with licensed offices in New York.

The Banking Department should require all foreign banks with branches or agencies in New York to adhere to BIS capital standards.

Continue to investigate banks' controlling owners as an important part of the application process.



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Require foreign banks establishing offices in New York to be able to make information available to law enforcement authorities in New York at least as freely as Swiss banks.

Require banks that establish branches or agencies in New York to affirm that their worldwide capital stands behind the liabilities of the New York office.

Continue to admit well-managed, well-capitalized banks to do business in New York even if their home countries have financial instability if the Superintendent is satisfied that restrictions placed on them will protect those who deal with them.

Apply less stringent standards to representative office applications than to branch and agency applications, provided that the applying bank has a sound business plan that does not include soliciting retail deposits and a reputation for integrity. Home country supervision of representative offices need not meet all entry criteria for branches and agencies.

Not all entry criteria should be established by statute. The Banking Board should be enabled to promulgate regulations regarding criteria.

Over an unspecified period of time, existing offices gradually should be brought into compliance with new entry standards.

## FORMS OF ORGANIZATION AVAILABLE

Branch powers presently exercised are appropriate and are not significantly changed by FDICIA. Branches should continue to be able to hold non-retail deposit accounts that fall below $100,000.

Require agencies to adhere to the same loans-to-one-borrower rules and 5% asset pledge as branches; if

agencies then have no different functions from branches, they should be phased out and converted into branches without a new application.

In order to assure that all branches or agencies have a minimum asset pledge amount, modify the pledge requirement to the greater of (i) 5% of deposits not including IBF deposits, (ii) 1% of deposits including IBF deposits, or (iii) $1 million.

Subject all representative offices to licensure, examination and supervision.

Permit representative offices to engage in loan-related activities that are wholesale in nature as defined by the Superintendent, ~~provided that they take no~~ deposits or cash for any purpose, advance no cash, issue no letters of credit or other obligations, and solicit no retail deposits.

Prohibit representative offices from soliciting retail deposits, and make violation of this prohibition a criminal offense.

Prohibit representative offices from occupying ground floor space or space near a money transmitter, except with the approval of the Superintendent.

The Superintendent should continue to license banking-type Article XII investment companies.

The Banking Department should supervise banking-type Article XII companies like banks and should continue to maintain capital standards, to regulate transactions with affiliates in a manner that prevents abuse and to apply diversification and loans-to-one-borrower standards.

Article XII companies should be permitted to have non-depository fiduciary powers.



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Change the name of Article XII companies from "investment companies" to a name that would be less confusing.

## REGULATION OF OWNERS

Foreign banks with unincorporated offices in New York should be required to obtain approval for 25%-or-greater changes in control. Permit them to make application for change in control approval either before or after the change.

Change in control approval should not be required if either (i) the servicing bank already is licensed to do business in New York, or (ii) the transaction has been approved by the bank's home country supervisor under procedures that are acceptable to the Superintendent.

Require parties applying for change in control approval to submit to the jurisdiction of the State for purposes of enforcing laws related to the ownership of the bank.

## OFFSHORE BRANCHES

Clarify the definition of a New York branch liability by means of a specific documentary test, as outlined in the Liquidation section below. Under this test, the branch designated to carry the transaction on its books should be the determinative factor.

Records should be required to be kept in New York for all transactions effected by New York personnel.

No retail deposits of U.S. persons (as defined by the Superintendent) should be taken or solicited for offshore branches in New York.

New York activities of offshore branches should be subject to New York examination and supervision.

## EXAMINATION ISSUES

The Banking Department should seek to use and evaluate the work of others where appropriate and should coordinate its examinations with federal authorities.

The Banking Department should have a professional staff that specializes in examining foreign banks.

The Banking Department should continue to accept filings on federal forms, where possible, to avoid duplication.

The Banking Department should continue to require each foreign bank to maintain appropriate internal controls for off-balance-sheet transactions and should consider requiring outside auditors to opine on the adequacy of such controls.

The Banking Department should assure itself that appropriate internal controls are in place at any office which has a large payments volume in relation to its asset size.

## SUPERVISION OF BRANCHES/AGENCIES TO PROTECT NEW YORK CREDITORS

When foreign banks doing business in New York show signs of financial weakness or other instability or their home country shows such signs, the Banking Department should implement a program that promotes asset diversification, restricts due-from-home-office accounts, protects against netting agreements, and imposes an asset maintenance regime. Off-balance-sheet obligations should be taken into account in administering asset maintenance.

Branches and agencies should not be required to maintain their own loan loss reserves unless they are subject to asset maintenance or the Banking Department is not



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satisfied that the bank as a whole maintains adequate reserves.

The law should permit netting agreements and no change in New York law on set-off is proposed, except that weak banks or banks from weak countries should be required to maintain accounts that are not subject to netting agreements.

Prohibit banks subject to asset maintenance from engaging in detrimental non-arms-length transactions with home office or affiliates.

## LICENSE TERMINATION

Expand the grounds for license termination to include such entry standards as the Banking Board may designate.

A hearing should be required before license termination.

The Superintendent should be empowered to supervise and continue to examine the withdrawal of any terminated licensee.

## LIQUIDATION ISSUES

New York creditors should continue to have a preference with respect to New York assets.

Amend New York law to provide that the Superintendent shall pay excess assets first to liquidators in other U.S. jurisdictions which have reciprocal arrangements, second to liquidators in other U.S. jurisdictions, in each case in proportion to any shortfall that they experience, and then any remainder to home country liquidators. The IBA should be amended to change the existing rule that if there is a federal branch of a failed bank, then all U.S. offices are to be liquidated under the federal rules.

The definition of New York creditors should be amended to establish a clear test for liquidations under which the place a transaction is booked is presumed to be correct. The law should require written or electronic advices in all liability transactions, and this advice should be required to designate the office for whose account the transaction is performed. The advice, if genuine, not clearly a mistake, and not promptly objected to, would be conclusive.

Foreign exchange, interest rate, and commodities transactions should be governed by similar rules defined by the Banking Board.

Damage of a tortious or fraudulent nature caused by New York personnel should be a New York liability in New York office liquidations.

No change is required in the definition of New York assets.

The Superintendent, as liquidator under the Banking Law, should have the benefit of a rule similar in substance to the federal rules under the D'Oench Duhme case.

The Superintendent should have explicit power to disaffirm executory contracts for real estate, goods, services or employment with no claim for future obligations accruing after the date of disaffirmance.

Qualified executory financial contracts ("QFC's"), which include futures, forward, swap and similar contracts, should be deemed terminated at the time the Superintendent takes possession and damages should be assessed to either side based on market profit or loss at that time.

The liability side of a QFC should govern whether the transaction is deemed a New York transaction for liquidation purposes.



The Bankruptcy Act should be clarified to make clear that New York law governs the liquidation of assets defined as assets of a New York branch under New York law.

The law should be made clear that the Superintendent is entitled to the appointment of a single judge to handle a liquidation.

The Superintendent's power to compromise claims should be increased from $250 to $25,000.

The Superintendent should be allowed 60 days rather than 30 days to rule on claims.

There should be an automatic stay of pending litigation against a branch or agency after the Superintendent has taken possession.

Contracts with service providers entered into by the Superintendent as liquidator should not require approval of the State Comptroller.

## BANKING DEPARTMENT FUNDING

The Banking Department should have independent budgetary authority so that it can pay salaries necessary to attract and retain the personnel necessary to supervise foreign banks and so that it can incur the necessary costs attendant to playing an important role in the supervision of transnational banks.

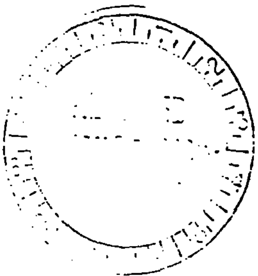


AMI-ADD-212

Chairman
Global Financial Institutions

World Financial Center
North Tower
New York, New York 10281-1332
212 449 8727

January 27, 1992



The Honorable Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System
20th & Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Chairman Greenspan:

Last fall the Superintendent of the State of New York Banking Department established a special committee, the Superintendent's Advisory Committee on Transnational Banking Institutions (the "Committee"), to study the issue of foreign bank supervision in New York. I have the honor to serve as Chairman of the Committee.

Although the study is not yet complete, an important matter regarding the supervision of foreign banks has been brought to the Committee's attention which the Committee believes requires immediate action. Accordingly, at its last meeting the Committee decided that I should write you to advise you of the Committee's thoughts and concerns.

Section 214(a) of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") amends Section 6 of the International Banking Act of 1978 (the "IBA"), which relates to the insurance of deposits at United States branches of foreign banks. There was no indication in the Congressional debates or the Committee reports that Section 214(a) was designed to implement a major change in the insurance structure for U.S. branches of foreign banks. Indeed, the clear message in the floor debates and other statements by Congressional leaders is that no such major change was intended.

Nonetheless, because of ambiguity in the statutory language, occasioned in large part by the deletion of a single word without any apparent Congressional endorsement, the question has been raised whether Section 214(a) has in fact implemented a major revision of the insurance scheme for foreign banks. Stated with greater specificity, it is undisputed that Section 214(a) provides that foreign banks may not hereafter establish insured branches to accept insured deposits. The question is whether Section 214(a) went much further and prohibited U.S. branches of foreign banks from accepting or maintaining certain non-retail deposit accounts



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that these branches have been permitted to accept ever since enactment of the IBA. We understand that this question is presently the subject of review by the federal banking agencies and will require implementing regulations or interpretations.

We do not intend in this letter to analyze the legal issues involved. Rather, we want to express our concern over the policy implications of a federal regulatory interpretation of Section 214(a) that would impose additional, substantial burdens on the operations of foreign banks in the absence of evidence that this was intended by Congress.

The results of our study to date confirm that foreign banks have been highly valuable to the banking public and the overall economic condition of the State of New York. Foreign bank branches have provided an important source of both credit and employment, as well as being users of numerous ancillary services. More generally, the foreign bank operations have contributed significantly to the status of New York, and thereby the nation as a whole, as the financial and economic center of the world. The vast majority of foreign banks have attempted to abide scrupulously by U.S. laws and regulations.

Accordingly, we believe that the bank regulatory agencies should be loath to interpret ambiguous legislation as imposing substantial new limitations on foreign bank operations in the United States, absent a demonstrable need. Such a regulatory position is particularly compelling in this case, because the extrinsic evidence indicates that Congress did not intend such a result and there has been no opportunity for meaningful debate or consideration of the consequences. The absence of any such Congressional intent is not surprising. We are unaware of any expressed view that the present insurance structure for foreign banks has been abused, creates safety and soundness concerns, has resulted in losses for depositors or has resulted in a competitive imbalance.*

A different regulatory position would inevitably threaten the important contribution that foreign banks have made and are likely to continue to make to this country's economy. If foreign banks perceive themselves as unfairly treated, they will shift their international business to other international finance centers. If foreign banks cannot compete on even terms, many will choose not to compete. U.S. banks would be subject to both formal and informal retaliation abroad, and the United States would find it increasingly difficult to defend free trade policies.

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* Although foreign banks with U.S. branches are generally treated similarly to U.S. banks, in a number of areas the regulatory scheme differs. The IBA represented an attempt to strike a balance of competitive equality. That balance would be undone if any major provision of the IBA were significantly revised.



AMI-ADD-214

January 27, 1992

If the federal banking agencies were now to adopt a restrictive interpretation of Section 214(a), the harm would be irrevocable even if such interpretation were later changed or overridden by Congress. In the interim, operations of and accounts at the U.S. branches of foreign banks would need to be significantly altered. Of even more importance, the willingness of the banking agencies to adopt a restrictive position would send a powerful message to foreign banks as to an overall change in regulatory approach that could not be undone irrespective of later changes.

In the final analysis, we believe that supervision of depository institutions is most highly enhanced by a basic legislative and regulatory scheme that promotes healthy institutions, competitive institutions and respect by the institutions for the regulatory process. We believe that an interpretation of Section 214(a) that limits its scope to a restriction on future insured branches would advance these three goals.

Representatives of the Committee and the Superintendent would be pleased to meet with your staff to discuss these issues if you felt that such an interchange would be helpful. We appreciate your consideration of our views.

With kindest regards, I am

Sincerely yours,

JGH:kr

bccs: Derrick D. Cephas
Superintendent's
Advisory Committee

STATE OF NEW YORK
BANKING DEPARTMENT
TWO RECTOR STREET
NEW YORK, NY 10006

DERRICK D. CEPHAS
SUPERINTENDENT OF BANKS

February 4, 1992

The Honorable Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System
20th & Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Chairman Greenspan:

As Superintendent of Banks of the State of New York, I am writing to express my concern about the potential impact of Section 214(a) of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") on uninsured state-licensed branches and agencies of foreign banks. Section 214(a) amends Section 6 of the International Banking Act of 1978 ("IBA") to prohibit international banks from accepting insured deposits except through an insured bank subsidiary. As the primary regulator of approximately 70% of the total foreign bank branch and agency assets in the United States, we strongly recommend that the Board of Governors act quickly to alleviate the substantial uncertainty in the foreign bank community as to the impact of this provision on the ability of foreign bank branches and agencies to continue to accept and maintain non-retail, foreign source and "de minimis" uninsured accounts under $100,000.

The uncertainty arises from the deletion of the word "retail" from the text but not the heading of Section 214(a), without any evidence of Congressional endorsement. The deletion creates an ambiguity as to whether Section 214(a) has in fact implemented a major revision in the corporate structure and the deposit insurance scheme of foreign banks operating in the U.S. It seems clear that under Section 214(a) foreign banks may not hereafter accept <u>insured deposits</u>, as that term was commonly understood prior to the enactment of Section 214(a), except through a separate insured bank subsidiary. The question is whether Section 214(a) was intended to go much further and require foreign banks that have been permitted to accept or maintain non-retail, foreign source and "de minimis" uninsured deposit accounts in

uninsured U.S. branches since the original enactment of the IBA to hereafter refuse to accept such accounts (and terminate existing accounts) or maintain them in separately capitalized insured bank subsidiaries. We understand that the federal banking agencies are presently reviewing this question in connection with drafting implementing regulations or interpretations.

Foreign banks represent an important segment of the New York economy and offer significant benefits to the banking public, both in New York and elsewhere in the U.S. Foreign bank operations have contributed enormously to the status of New York as the world's leading financial center. The importance of New York as an international center for foreign banks is evidenced by the fact that 71% of the approximately $850 billion in assets of foreign banks in the United States are held at New York offices. These banks provide a significant number of jobs both directly and as users of services and contribute significantly to economic development in New York. Foreign banks engage in trade financing and lending to U.S. subsidiaries of home country corporations and to U.S. multinational companies. Many of the larger banks are major participants in the interbank and foreign exchange markets.

Foreign banks operating uninsured branches in New York have historically accepted certain limited categories of deposits in amounts of less than $100,000 without having to obtain federal deposit insurance under long-standing exemptions of the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC"). The exempt deposits include business and government deposits, foreign source deposits and "de minimis" deposits. We believe that the federal banking agencies should interpret Section 214(a) to preserve these exemptions absent a clear Congressional message to the contrary. An interpretation that would impose substantial new limitations on foreign bank operations in the United States could have a serious negative impact on the U.S. operations of foreign banks without any corresponding public benefits. So far as we can determine, there is no clear evidence that Congress intended such a result; indeed, we understand that several Congressmen have explicitly disclaimed any such intention.

The legislative history of the FDICIA indicates that the intent of Congress in enacting Section 214(a) was to require foreign banks to take insured retail deposits only through insured bank subsidiaries because of a concern for risk of loss to the Bank Insurance Fund. There is no suggestion in the available legislative history that Congress was concerned with the limited acceptance of deposits of less than $100,000 by uninsured branches that has long been authorized by the FDIC and OCC exemptions. We are not aware of any view expressed by Congress or any federal bank regulator that the present insurance structure for foreign banks



AMI-ADD-217

has been abused, creates safety and soundness concerns, or has resulted in a competitive imbalance between foreign and domestic banks. It is our understanding that depositors with uninsured accounts in foreign bank branches do not expect these accounts to receive the benefits of FDIC insurance. Further, there are no policy reasons to voluntarily extend insurance coverage to these deposits in the event of a branch failure.

A regulatory interpretation that does not preserve the existing FDIC and OCC exemptions would threaten the important contribution that foreign banks have made and are likely to continue to make to New York's economy and the U.S. economy as a whole. Such an interpretation would send a powerful message to foreign banks as to an overall change in regulatory approach that could lead to a significant shift in their international business to other international financial centers outside the U.S. Domestic U.S. banks may be subject to retaliation abroad. Other countries could require U.S. banks to conduct their banking business in separately incorporated subsidiaries, a highly undesirable result in our view.

We respectfully recommend that the Board of Governors interpret Section 214(a) to preserve the existing non-retail deposit exemptions for uninsured branches of international banks or, in the alternative, support a legislative amendment to clarify this ambiguity.

Very truly yours,

cc: The Honorable Donald W. Riegle, Jr.
The United States Senate

The Honorable Henry B. Gonzalez
The United States House of Representatives