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OPPORTUNITIES FOR REGULATORY ARBITRAGE UNDER THE EUROPEAN ECONOMIC COMMUNITY’S FINANCIAL SERVICES DIRECTIVES AND RELATED UNITED STATES REGULATIONS

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OPPORTUNITIES FOR REGULATORY ARBITRAGE UNDER THE EUROPEAN ECONOMIC COMMUNITY'S FINANCIAL SERVICES DIRECTIVES AND RELATED UNITED STATES REGULATIONS

I. INTRODUCTION

The European Economic Community ("EEC")\(^1\) directives for banks and investment firms dictate financial and operational regulation primarily along traditional functional lines.\(^2\) However, the definition of "bank" has always been more expansive in Europe than in the United States ("U.S.").\(^3\) In general, the EEC's approach to financial regulation has involved an accommodation rather than a reconciliation of the regulatory

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1. The Treaty of Rome created the EEC. *A Brief Introduction to European Law, Directives*, 3, available in WESTLAW, CELEX-LEG Database. It is comprised of twelve member European states. *Id.* § I.I. A Parliament has been set up comprised of representatives of all member states. Through consideration of various council and committee proposals it passes legislation by which the member states consider themselves bound. *Id.* § II. Directives are analogous to U.S. statutes as they are legislative acts of Parliament. *Id.* The member states then implement, through amendments of their domestic laws, the legislation of the EEC. *Id.* Regulations are similar to U.S. administrative law, but with more force in that they are acts of Parliament. However, regulations are not passed on by the members' domestic legislators. *Id.*

2. "Traditional functional lines" here means banking, securities, and insurance services. However, it should be noted that the definitions of such vary not only between the United States and Europe, but also among the European countries. *See generally T. HAZEN, THE LAW OF SECURITIES REGULATION* § 19.5 (2d ed. 1990).


The term "bank" will be used interchangeably with "credit institution." However, it should be noted that outside of the U.S., the term "bank" generally encompasses many of the activities that are also conducted by U.S. securities broker-dealers and investment banks. *See* discussion *infra* at part II.C.1.
schemes of the different European countries. The EEC’s recently enacted Second Banking Directive ("Second Directive") and Investment Services Directive ("ISD") reflect both these tendencies.

As a result of these directives, there may well be a greater consolidation of European financial institutions which could result in more financial conglomerates. The Second Directive and ISD emphasize the protection of the institution against insolvency by the usual capital adequacy mechanisms of assigning various market and credit risk factors to proprietary businesses along product lines. Yet, U.S. regulation continues the traditional separation of banking and securities activities. Consequently, this disparity will create both opportunities and hazards for U.S. financial institutions operating in the EEC.

This paper first compares the EEC directives and relevant U.S. banking and securities regulations governing foreign operations. The analysis signals opportunities for "regulatory arbitrage," as well as

4. "The single banking license will be mutually recognized by all Community supervisory authorities. This recognition will however be subject to the provision that banks only undertake those banking activities in other member states, which the authorities in the home country allow them to undertake domestically . . . ." EUROPEAN UPDATE, Banking and Financial Services, § 3.31 (June 9, 1993) (Main Text) available in WESTLAW, EURUPDATE Database, 1991 WL 11696 [hereinafter EUROPEAN UPDATE].


8. Capital Adequacy Directive, Council Directive 93/6, 1993 O.J. (L 141) 1 [hereinafter CAD]; ISD, supra note 6. There are various forms of financial regulatory mechanisms; for a more detailed comparison of theses methods as employed in the United States, see Gary Haberman, Capital Requirements of Commercial and Investment Banks: Contrasts in Regulation, FED. RESERVE BANK OF N.Y. Q. REV., Autumn 1987, at 1, 8. Capital adequacy ratio is a method whereby the assets of financial services firms are assigned percentage weightings that increase with market illiquidity or credit risk. The resulting ratio is a function of the illiquid assets divided by a base capital figure, which is generally equal to equity capital plus certain subordinated debt. Another common method of capital measurement is the Net Capital Ratio. This ratio is generally calculated by applying market or credit risk factors to all categories of assets and deducting this sum from a base capital figure, which is analogous to that of capital adequacy. This adjusted capital amount is then divided by a liquid asset figure, usually customer receivables. Id.

9. This note does not deal with insurance regulation, which may also be considered a "financial service." See, e.g., USA: U.S. Law Extends its Claws into European Insurance/Banking Alliances, Reuter Textline, July 16, 1991, available in LEXIS, World Library, ALLWLD File.
inconsistencies between U.S. and EEC regulation that require careful planning. Finally, amendments to the U.S. banking and securities rules are reviewed to indicate the direction the lawmakers are taking with respect to increasing foreign competition and the continued opposition to liberalization of regulation of the U.S. securities industry.

II. THE STATUTORY FRAMEWORK OF THE EEC AND U.S. RULES

A. EEC Regulation of Banks and Investment Firms:
The Financial Services Directives

Similar to U.S. capital rules, the Second Directive and the ISD emphasize the protection of the firm against insolvency by the usual capital adequacy mechanisms of assigning various market and credit risk factors to proprietary businesses along product lines. However, the EEC's approach to financial regulation is an accommodation rather than a reconciliation of the regulatory schemes of the different European countries. For example, rather than dictating which activities are banking and which are not, the Second Directive provides a list of activities "subject to mutual recognition" by the other members of the EEC.

The Second Directive, issued in 1989, calls for a uniform license arrangement among the twelve members of the EEC. The purpose of both the treaty and the directive is to provide for overall supervision of credit institutions within the EEC by the home regulator, while coordinating such with the host country regulators. This principle has carried through to the ISD. Credit institution is defined by reference to the definition contained in Article 1 of the First Banking Directive.

10. CAD, supra note 8.
11. EUROPEAN UPDATE, supra note 4, § 3.31.
13. Second Directive, supra note 3, pmbl. The uniform license would provide for the home country to issue a license to the financial institution that would be valid throughout all member states. Id.
14. "Home" refers to the member country in which the financial institution is chartered; "host" refers to the member country wherein the financial institution will operate as a subsidiary, affiliate, branch or agency. See Nancy Louise Kessler, Banking on Europe: 1992 and EMU, 60 FORDHAM L. REV. S395, S400-402 (1992).
15. ISD, supra note 6, art. 3.
Therein, a credit institution is defined simply as a "means or undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account." The Second Directive carries over this definition and adds to it a list of other activities, discussed below, to be mutually agreed upon. An investment services firm is any firm that does not receive deposits, grants credits, and carries on at least one of the activities listed in Section A of the annex to the ISD. All of the activities listed in Section A are also included in the annex to the Second Directive as acceptable activities for credit institutions to engage in. Therefore, a credit institution can also be an investment services firm, but the latter cannot be a credit institution unless it receives deposits and grants credits.

Because the member states each have varying definitions of a "bank," the directives also seek to create conditions for reciprocity among the various financial institutions by listing the more common activities of credit institutions and investment services firms that are subject to mutual recognition. Although the Directives anticipate that the individual countries will amend their own statutes to conform to the directives, host countries may impose stricter or different requirements on foreign firms, provided the domestic firms are subject to identical regulation. The home country is the primary regulator and is the one which grants the license. Ideally, as stated in the preamble to the banking directives, this scheme depends upon cooperation and coordination between the members’ regulators.

17. Id. Although this definition is similar to U.S. law (compare 12 U.S.C. § 214 (1994)), the Second Directive, while keeping the base definition, included activities not typical of U.S. banking operations.
19. ISD, supra note 6, annex.
22. Second Directive, supra note 3, art. 1, annex 1; ISD, supra note 4, arts. 1 & 2 and annex.
23. A Brief Introduction to European Law, supra note 1.
The Second Directive lists activities that the single license governs.\textsuperscript{27} The license covers acceptance of deposits, lending, issuing and administering means of payment (e.g., credit cards, drafts, checks, etc.), financial leasing, and guarantees or commitments.\textsuperscript{28} However, and more important to certain countries, the Second Directive would also include securities business activities such as proprietary trading, agency trading for customers, participation in share issuances, portfolio management and advice, and safekeeping and administration of securities.\textsuperscript{29} Banks may also become stock exchange members.\textsuperscript{30} Significantly, the Second Directive now confirms that the license, once issued, is valid throughout any and all member states of the EEC to provide the aforementioned services.\textsuperscript{31}

In addition, there is provision for reciprocity for non-EEC banks to obtain a license.\textsuperscript{32} If a non-EEC country does not permit similar competitive advantages to the EEC member bank or investment firm in its country, the non-EEC financial institution may be denied a license for a particular EEC country.\textsuperscript{33} At present, there is provision for the grandfathering of non-EEC financial institutions that are already established in the individual countries.\textsuperscript{34}

\textbf{B. U.S. Regulation of U.S. Banks and Brokers in the EEC}

1. Banking Regulation

U.S. commercial banking is usually defined as the taking of customer deposits and, in turn, lending them out to commercial entities or individuals in the form of short-term or long-term loans and mortgages.\textsuperscript{35} This circumscription of activities arises from the collective effect of

\textsuperscript{27} Second Directive, \textit{supra} note 3, annex 1.
\textsuperscript{28} \textit{Id.} annex ("List of Activities Subject to Mutual Recognition").
\textsuperscript{29} \textit{Id.}
\textsuperscript{30} COOPERS \& LYBRAND, EC COMMENTARIES: BANKING AND SECURITIES § 14.8 (Sept. 9, 1993), available in LEXIS, Eurcom Library, EURSCP File.
\textsuperscript{31} Second Directive, \textit{supra} note 3, art. 18.
\textsuperscript{32} \textit{Id.} art. 9.
\textsuperscript{33} \textit{Id.} However, as one commentator has noted, "[The term] 'reciprocity' has been changed to 'relations with third countries,' signaling that retaliation is not the main objective." Udo-Olaf Bader, \textit{Regulation by the European Communities}, in \textit{REGULATION OF FOREIGN BANKS}, \textit{supra} note 21, § 11.04.A.1.
\textsuperscript{34} COOPERS \& LYBRAND, \textit{supra} note 30, § 3.5.
\textsuperscript{35} Franklin Nat'l Bank v. N.Y., 347 U.S. 373 (1954).
several legislative acts.

The Bank Holding Company Act of 1956 ("BHCA"), as amended, essentially prohibits bank holding companies from owning more than five percent of the shares of a company that is not a bank.\textsuperscript{36} Under U.S. banking laws, nonbanks include investment banks,\textsuperscript{37} securities broker-dealers, and industrial concerns. In addition, the Edge Act does not permit foreign branches of U.S. banks to "engage or participate, directly or indirectly, in the business of underwriting, selling, or distributing of securities."\textsuperscript{38} Similarly, under the Edge Act and the BHCA, foreign branches of U.S. securities broker-dealers would be precluded from banking activities abroad without becoming subject to the BHCA.\textsuperscript{39} Finally, the Federal Deposit Insurance Corporation Improvement Act of 1991 ("the Improvement Act") limits U.S. banking activities abroad by prohibiting FDIC insurance of deposits outside the U.S.\textsuperscript{40}

However, Federal Reserve Board ("Board") Regulation K has been relaxed to expand the scope of permitted banking activities abroad.\textsuperscript{41} Although the Glass-Steagall Act, by its terms, does not control banking activities outside of the United States,\textsuperscript{42} the BHCA has been interpreted to apply to such activities while at the same time creating exemptions to conduct "nonbanking" activities with either regulation or Board approval.\textsuperscript{43}

The Board has been allowed to interpret its Congressional authority broadly. For example, the Board is permitted to authorize those activities that it defines to be "usual" in connection with the transaction of banking or other financial operations.\textsuperscript{44} The Board has determined that "usual" includes the following: underwriting, distributing, and dealing in equity and debt securities outside of the United States (with certain limitations on


\textsuperscript{37} For an extensive analysis of the differences between investment and commercial banking and the development of the investment banking business, see United States v. Morgan, 118 F.Supp. 621 (S.D.N.Y. 1953).


\textsuperscript{39} Id.; Bank Holding Company Act § 1843.


\textsuperscript{41} International Banking Operations, 12 C.F.R. § 211 (1993) (Regulation K); see also Nonbanking Activities and Acquisitions by Bank Holding Companies, 12 C.F.R. § 225 (1993) (Regulation Y).


\textsuperscript{44} Id. at 217.
equity securities); organizing, sponsoring, and managing mutual funds; acquiring up to 100% of a foreign government or governmental agency corporation’s stock or up to 40% of foreign private corporations; merchant banking; acting as Futures Commissions Merchant and, by incorporation of Regulation Y, permitting securities and commodities brokering by the foreign affiliate. Banking activities include “commercial and other banking activities, financing, leasing, underwriting credit life insurance and credit accident and health insurance, underwriting, distributing and dealing in debt securities outside the United States, and limited equity underwriting.” Regulation Y provides a “[l]ist of permissible non-banking activities” that are “so closely related to banking . . . that they may be engaged in by a bank holding company or a subsidiary thereof . . . .” Among the most important allowable Regulation Y activities are securities brokerage operations, but they are limited to agency transactions for customers and restricted investment banking business. The exemption for these activities is now generally limited by capital utilization and total equity.

2. Securities Broker-Dealer Regulation

“[The SEC] uses an entity approach with respect to registered broker-dealers. Under this approach, if a foreign broker-dealer physically operates a branch in the United States and thus becomes subject to U.S. registration requirements, the registration requirements and the regulatory system governing U.S. broker-dealers would apply to the entire foreign broker-dealer entity.” SEC Rule 15a-6, promulgated in 1989, permits exemptions for registration of foreign broker-dealers who operate in foreign countries and who have limited contacts with U.S. citizens, and

45. See supra note 49 and accompanying text.
46. Regulation K § 211.5(d).
47. Regulation Y § 225.25(a).
48. Id. § 225.25(b)(15)(i).
49. The amended Regulation K now permits U.S. banks to engage in limited underwriting and securities activities abroad limited to “25% of the investors’ tier 1 capital [where the investor is a Bank Holding Company]” or 100% of the same for all other investors. Regulation K § 211.5(b).
U.S. registrants or U.S. securities as regulated under the Securities Act of 1933 ("SA"). 51 This regulation covers foreign broker-dealer affiliates of U.S. broker-dealers as well. As one commentator aptly noted, "Rule 15a-6 is the SEC's effort to fill a regulatory void, . . . [while] Regulation K . . . is the Board's interpretation and amplification of U.S. banking law." 52

The rule requires regulation of the foreign broker unless the broker falls within one of the rule's exemptive provisions. 53 If the foreign broker-dealer does not fall within the exemptions permitted, the broker will become subject to all the financial and operational requirements of the Securities Exchange Act of 1934 ("1934 Act"). 54 "[S]ection 30(b) of the Exchange Act [excludes] from the application of the [1934 Act] 'any person transact[ing] a business in securities without the jurisdiction of the United States,' in the absence of Commission rules explicitly applying those provisions to these persons." 55 However, the SEC's position on 30(b) has been and continues to be that "the phrase 'without the jurisdiction of the United States' in that section does not refer to the territorial limits of the [the United States]." 56 Furthermore, if the foreign country's laws prohibit or inhibit the SEC from obtaining information to ensure initial or continued compliance with exemptions, the SEC can withdraw its exemption. 57

The exemption is unconditional for foreign broker-dealers that effect unsolicited transactions in securities 58 and, to a limited extent, for those broker-dealers who provide research reports to U.S. institutional investors, provided the research reports do not recommend the use of the foreign broker-dealers to effect the trades in any security and do not otherwise attempt to induce the use of the foreign broker-dealers's services by the U.S. institutions. 59

However, the more onerous exemptive provisions lie in subsection

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51. Id.
53. SEC Rule 15a-6(a).
54. SEC Rule 15a-6.
55. Release 15a-6, supra note 50, at 30,016 (quoting 17 U.S.C. 78dd(b)).
56. Id.
57. SEC Rule 15a-6(c), 17 C.F.R. § 240.15a-6(c).
58. Id. (a)(1).
59. Id. (a)(2).
(a)(3) of the rule. Here, if the foreign broker-dealer "induces or attempts to induce the purchase or sale of any security by a U.S. institutional investor," which is the more likely scenario in a competitive global market, it must register unless it meets the following safe-harbor tests: (1) the foreign broker-dealer effects the transaction through a U.S. domestic broker-dealer; and (2) the investor must be "sophisticated" (have assets greater than $100 million). At the same time the SEC released Rule 15a-6, it issued a "Concept Release," which would provide for recognition of comparable foreign broker-dealer regulation. The Concept Release would permit exemption from the first criterion of Rule 15a-6 if (1) the foreign broker does not have a U.S.-related securities business greater than ten percent of its total securities revenues and does not have a U.S. broker-dealer affiliate and (2) the foreign country's regulatory scheme must be comparable to that found in the U.S. This last requirement of course is rather amorphous. For example, the rule calls for the foreign country's scheme to provide for (1) a net capital rule; (2) recordkeeping rules; (3) custody or safekeeping of customer's assets; and (4) the SEC to examine "the status of customers' funds and securities [if] the foreign broker-dealer is adjudicated bankrupt."

C. Summary of Significant Differences in the U.S. and EEC Rules

There are three U.S. financial regulatory schemes in place that will present either competitive advantages or disadvantages to U.S. affiliates doing business in the EEC. The first is the separation of commercial and investment banking. The second is the limitation on ownership or control of non-banking affiliates by a bank or bank holding company. Finally, there is the "reserve requirement" imposed by the SEC on customer assets held by securities broker-dealers.

Significantly, although these three areas may represent potential for opportunity or conflict, these activities and requirements are encompassed by both U.S. and EEC rules. The issue then becomes the extent to which

60. Id. (a)(3)(iii).
64. Bank Holding Company Act.
they are permitted or required under the U.S. rules. There are no absolute limits imposed by EEC rules, only mutual recognition. For example, the list of activities under Annex 1 to the Second Directive is quite similar to the list of "permissible" investments and non-banking activities under Regulations K and Y. In addition, the record keeping and retention rules, sales practices rules, and protection of customer asset rules of the ISD are very similar to the SEC rules. But, as noted earlier, the similarity ends there. It is the degree to which the respective entities may engage in the various activities and the extent to which customer assets must be safeguarded that distinguishes U.S. and EEC regulation. The opportunities for regulatory arbitrage lie therein.

1. Separation of Investment and Commercial Banking

The separation of investment and commercial banking is not common worldwide. Apart from Japan, which recently amended its laws to approach those of the EEC, only the U.S. has almost complete institutional separation of these two activities. The most recent attempt to dismantle the separation failed with passage of the Improvement Act. Generally, there are three stated reasons for the separation. First, underwriting securities is inherently risky and could result in systemic failure of the financial institutions if a large commercial bank failed as a result of a market collapse on a day the bank was holding an underwriting position. Second, the 1929 stock market crash and subsequent Depression were caused by the combination of securities broker-dealers and banks in that business. Third, commercial lending is the backbone of the economy.

66. Compare supra notes 24 and 41 and accompanying text to notes 54 and 56 and accompanying text.


68. Commercial banking is usually defined as the taking of customer deposits and in turn lending to commercial entities or individuals in the form of credit cards, short-term or long-term loans, and mortgages, whereas investment banking generally involves purchasing a commercial entity's public stock or debt upon initial issuance and then distributing it to the public through a securities exchange. See generally Haberman, supra note 8.


70. Koguchi, supra note 7.

71. See infra note 182 and accompanying text.
and investors and savers must not lose confidence in the banking system as a result of it being tainted by risky non-banking business. In contrast, most EEC countries permit both banks and nonbanks to carry out investment banking, securities dealing, and brokerage. Moreover, Japan has recently lowered its Glass-Steagall type barriers and now permits securities brokerage and dealing activities by banks and vice versa.

Unlike the EEC directives, U.S. securities and banking laws generally prohibit any securities brokerage activities by a bank unless it is effected by a "§ 20 affiliate" or its trust department. The exemption is limited to national banks and applies only to agency trading for customers. Some barriers to underwriting have recently been lifted through the easement of the Federal Reserve Board regulations or by order, and affirmed by Supreme Court decisions as not violative of the BHCA or Glass-Steagall Act. Recently, as a combined result of the Bank of Credit and Commerce International ("BCCI") and U.S. commercial and savings banks failures, there has been a backlash of regulation by Congress that affects both domestic banking and foreign banks wishing to do business in the U.S., as the legislative history to the Improvement Act attests. This reaction has elicited warnings from EEC President Brittan that imply that these rules are too protectionist and not congruent with the EEC directives.

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73. Nancy Worth, Harmonizing Capital Adequacy Rules for International Banks and Securities Firms, 18 N.C. J. INT'L L. & COM. REG. 133, 152-3 (1992) (listing the following countries: Germany, Austria, Switzerland, Belgium, France, Greece, Italy, Luxembourg, the Netherlands, France, Portugal, Spain, and the U.K.).
74. Koguchi, supra note 7.
76. See Regulation Y.
79. EEC/U.S.: Brittan Warns of Threat to European Banks from U.S. Reforms, EUR.
2. The Universal Bank and Ownership or Control of or by Non-Banking Affiliates

In contrast to U.S. regulation is the concept of the universal bank.\(^{60}\) The universal bank permits industrial, banking, and securities activities to take place in one entity.\(^{61}\) Moreover, universal banks may own or be owned by a controlling interest in a commercial or industrial concern, for instance as an automobile manufacturer.\(^{62}\) These financial "supermarkets" are common in three EEC countries: Austria, Germany, and Switzerland.\(^{63}\)

Recent statistics have shown that over ten percent of commercial equity is controlled by universal banks in Germany.\(^{64}\) The amount owned by these banks has steadily increased over the past decade and in many cases represents controlling interests in these commercial entities.\(^{65}\)

Under German law (a proxy for universal bank law), a bank will not incur any excess capital charges on its loans to any one issuer unless the issuer owns (or controls) greater than 25\% of the bank's stock (or its board of directors).\(^{66}\) There apparently is no limit on deductions for such loans, provided the bank can maintain minimum capital requirements. Moreover, a German bank will not incur excess capital charges on its loan portfolio, unless a particular issuer's loans exceed 15\% of a bank's regulatory capital.\(^{67}\) No single loan may exceed 50\% of such capital, and all such loans in the aggregate can not exceed eight times regulatory capital.\(^{68}\) This limit is absolute.

Under the Second Directive, banks are limited to equity holdings of nonfinancial institutions of up to 15\% of their capital for a single entity,

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80. "[Universal banks] offer the full range of banking services . . . [t]here is no equivalent to the Glass-Steagall Act in . . . Germany. German law . . . do[es] not differentiate between commercial banks and investment banks." Ekkard Bauer, Regulation in Germany, in Regulation of Foreign Banks, supra note 21, § 13.07.

81. Id.

82. Roe, supra note 69, at 1949.

83. Worth, supra note 73, at 136.

84. Id. at n.95.

85. Id. at 1949.


87. Id. § 13.16.

88. Id.
and up to 60% of their capital for all such holdings. Member states may permit these thresholds to be exceeded if the bank deducts the excess amounts from capital. Similar to the German law, the Second Directive calls for increased capital charges and limits on concentrated loan positions. Under the Second Directive, large exposures are considered to be those loan values that are equal to or greater than 15% of the bank’s capital. Also similar to German law, these items are reportable to the banking supervisor. Under the Second Directive, banks are generally prohibited from holding concentrated positions that exceed 40% of capital and all such positions that would exceed eight times capital. This limit, like the German one, is absolute.

In contrast, under the BHCA of 1956 as amended, merger and conglomerate activities of U.S. banks are severely restricted. The BHCA prohibits the ownership or control of greater than 5% of a bank by non-bank companies. Importantly, the Board has extended the BHCA prohibition on ownership of the shares of a nonbanking company to banks. The Board justifies this by arguing that not to do so would circumvent the intent of the BHCA, as bank holding companies beneficially own the shares of its bank subsidiaries. There are exceptions to this prohibition for non-bank subsidiaries that are “so closely related to banking or managing or controlling banks as to be a proper incident thereto.” The exceptions and limitations to the ownership rules are enumerated in various sections of Regulation Y. Similar to the German and EEC law, there are concentration charges for large loans and exposures to any one issuer when calculating the minimum capital ratios. However, the BHCA 5% limitation on share ownership is not similar to German and EEC law. As a result, the Board has permitted, by regulation, banks to acquire up to 40% of foreign private corporation stock if the U.S. bank is doing business abroad. The regulation is very complex.

89. European Update, supra note 4, § 3.3.7.
90. Id. § 4.3.4.
91. Id. § 4.3.4.2.
92. Id. § 4.3.4.3.
93. Bank Holding Company Act § 1843(a).
94. Id. § 225.101.
95. Id.
96. Id. § 1843(c)(8).
97. Regulation Y §§ 225.21, 225.25.
98. Regulation K § 211.5.
99. Id. § 211.5(a).
Investments for purposes of the rule must be made through joint-ventures and are subject to revenue and (or) equity limitations as a function of the type of business the investing organization is engaged. Finally, as discussed earlier, the Glass-Steagall Act and related regulations prevent the ownership or control of greater than 5% of a bank or bank holding company by a non-bank. There is no such limitation under the EEC directives nor under German law.

3. Use of Customer Assets

Although it is rarely addressed, another significant distinction between U.S. bank and securities regulation is the segregation and reserve of customer assets. Securities broker-dealers, not by statute but by administrative regulation through SEC Rule 15c3-3, must bifurcate their balance sheets and securities holdings into firm and customer property. Through an elaborate regulatory scheme, broker-dealers are, in reality, custodians for fully-paid-for or excess customer margin securities and customer deposits. Securities firms may only use customer funds or securities to the extent necessary to meet margin requirements or collateralized financing needs of customers. This phobia of holding customer deposits is exemplified by a New York Stock Exchange rule, which prohibits, with certain limited exceptions, the payment of interest on idle customer funds at brokerage houses. This rule is neither required by any securities legislation nor enforced by the SEC. Finally,

100. Id.
101. See discussion infra part II.C.1.
103. Rule 15c3-3(a)(1) and Exhibit A.
104. Id. Exhibit A; 17 C.F.R. § 240.15c2-1 (1993).
106. Id. at 58,236 n.4. However, the SEC has also noted that balances retained at broker-dealers for the sole purpose of earning interest are not protected by SIPC. Id. at
to the extent that the assets of a customer of a broker-dealer (funds and securities together) exceed, in the aggregate, amounts owed primarily for margin transactions to the broker-dealer by all other customers, the excess must be deposited at a bank in a custodian account, either in cash or in government securities. The computation to determine this "reserve deposit" is performed weekly for most broker-dealers. However, the amount must be segregated for the entire week. Funds cannot be withdrawn without an additional computation of the requirement. And per the rule, the broker-dealer is expected to be in compliance with this calculation daily.

It is interesting to compare this rule to the requirements of banks. U.S. banks were subject to similar regulations which required that at the end of each day a relatively small percentage of customer deposit money had to be "reserved." This was accomplished simply by a bookkeeping entry and was more in the nature of a capital requirement than a custodial function. The requirement has more to do with Board monetary policy and systemic funding needs than customer protection.

III. OPPORTUNITIES AND CONCERNS CREATED BY THE DIFFERENCES

A. Introduction

For purposes of the following discussion, "regulatory arbitrage" is defined as varying economic efficiencies for identical financial transactions resulting from differing regulations over such transactions. The dissimilar regulatory effects in the same market are the result of institutions or

58,236-37.
107. SEC Rule 15c3-3(e).
108. Id.
109. SEC Rule 15c3-3(g).
111. The reserve required banks to leave funds at the regional federal reserve banks, interest free. This practice has changed somewhat in that the Federal Reserve now pays a discount rate. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 65 (7th ed. 1984).
112. Id. at 68-71.
products being subjected to different regulatory schemes. Regulatory arbitrage may result by effecting cross-border transactions. The present U.S. and European regulatory scheme invites regulatory arbitrage as was made painfully obvious by the recent collapse of BCCI. Financial institutions, and in particular banks, are no longer territorial in nature. As one author has noted, "[B]anking has become international; supervising it has not." The Second Directive and the ISD embody many of the U.S. requirements. For example, the requirement of segregation of customer assets is actually more stringent in the ISD because it has the force of legislation and is not simply a regulation. Also, the directives call for consolidated supervision and mandatory compensation schemes.

However, these requirements are not present in most countries. In fact, only the UK has a customer segregation rule, and many European countries have only piecemeal compensation schemes. In the U.S., the Market Reform Act of 1990 requires holding companies and certain other affiliates (both foreign and domestic) of broker-dealers to file quarterly information with the SEC. This is probably the first step toward consolidated or holding company regulation. Of course, U.S. banks have been subject to holding company regulation since the enactment of the BHCA.


115. ISD, supra note 6, pmbl., arts. 1-17.

116. Id. art. 10.


118. See generally THE SPICER & OPFENHEIM GUIDE TO SECURITIES MARKETS AROUND THE WORLD (Peter J. Oliver & Joel Press eds., 1988).

119. Id. at 216.

120. Id. at 238-41.


B. Regulatory Arbitrage Involving U.S. Rules

Present domestic and foreign regulatory schemes may give some competitive advantage to a U.S. Bank doing business in a foreign country. This is also true of those U.S. banks that conduct institutional business under Regulation K. At present, the regulatory arbitrage that the SEC was attempting to prevent by the issuance of Rule 15a-6 may be taking place.\(^{123}\) Ironically, arbitrage is augmented, domestically, not by the pending EEC regulation, but by the actions of U.S. regulators who may not have coordinated domestic rules regulating similar activity abroad.\(^{124}\)

Although it is clear that the SEC has jurisdiction over securities activities of U.S. banks, it is not at all apparent that it has the authority to regulate the foreign subsidiaries or branches of U.S. banks that are operating pursuant to the Regulation K criteria.\(^{125}\) U.S. securities dealers may have foreign banking operations under holding company affiliates, provided the activities are not violative of SEC Rule 15a-6 and Regulation K.\(^{126}\) However, there may be a gap in the regulations that permits Regulation K foreign banking affiliates to conduct their securities brokerage businesses with an advantage over a Rule 15a-6 securities dealer affiliate.\(^{127}\)

Reading certain sections of Regulations K and Y together\(^{128}\) suggests a U.S. banking affiliate in a foreign country may be permitted to function as a dealer, underwriter, and agent for securities brokerage business all under the same roof within the bank, which would be almost identical to an EEC institution.\(^{129}\) Although the underwriting and dealing activities are

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\(^{123}\) Regulatory arbitrage can be further defined as gaining economic advantage through reduced utilization of capital or other resources when effecting an identical transaction either in a different market or through entities that are regulated differently. This is solely because there are a different set of rules pertaining to such transaction simply as a result of the jurisdiction of the various regulators. See generally Worth, supra note 73, at 142-6.

\(^{124}\) Id. at 143 n.55 and accompanying text.

\(^{125}\) See supra note 46 and accompanying text.

\(^{126}\) See supra note 55 and accompanying text.

\(^{127}\) The apparent scope of Rule 15a-6 is limited to "foreign entities engaged in certain activities involving U.S. investors and securities markets." Release 15a-6, supra note 50, at 30,013. Consequently, it would not reach purely foreign securities activities. Id. However, Regulation K apparently has no such explicit constraints: it simply states, "Activities abroad, whether conducted directly or indirectly . . . ." § 211.5(a).

\(^{128}\) § 225.25(b)(15); § 211.5(d)(14), (19) and (20).

\(^{129}\) Regulations Y and K do not require that these businesses be conducted in separate
limited by regulation, permitting these activities in this form is the first substantial step toward giving U.S. banks a competitive edge over both U.S. securities dealers and foreign investment services firms doing business in the EEC. This conclusion depends on the reach of Rule 15a-6, which is not yet clear. Would the U.S. foreign banking entity be exempt from Rule 15a-6, if it did not effect its U.S. related transactions through a U.S. broker-dealer? In response to this question, the SEC would probably argue the following:

Section 3(a)(4) of the Exchange Act defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." The term "bank," however, is limited by section 3(a)(6) of the Exchange Act to banks subject to U.S. state or federal bank regulation. Thus, foreign banks that act as brokers or dealers within the jurisdiction of the United States are subject to U.S. broker-dealer registration requirements. Moreover, Regulation K exemptions do not speak to "required comparable foreign regulation" for permitting exemption of the various activities otherwise not allowed in the U.S. Thus, under the Concept Release, these activities would arguably be subject to SEC jurisdiction.

Several factors militate against SEC jurisdiction. First, it would undercut the purpose of Regulation K. Regulation K was promulgated to enable U.S. banks to compete with foreign financial conglomerates, which are viewed as having a competitive advantage because of their more permissive regulations in regard to securities activities. It would be ironic indeed, that such an attempt at broader worldwide competition would be thwarted by an SEC regulation working to close a "regulatory gap."

Furthermore, the SEC's jurisdictional basis to promulgate Rule 15a-6 stands on weak ground and has not yet been directly tested in the courts. Whenever the SEC asserts jurisdiction over transactions outside the territory of the U.S., lower courts have relied on the "effects" or

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131. Id. § 78c(a)(6)
132. Release 15a-6, supra note 50, at 30,014 n.16.
133. See supra note 68 and accompanying text.
134. Trachtman, supra note 52, at 256-57.
135. Id. at 276-79.
"conduct" tests to determine whether subject matter jurisdiction is permitted under § 30(b). The tests ask (1) whether domestic investors or markets are substantially affected or (2) whether the nature of the conduct within the U.S. permits the U.S. to be used as a base for manufacturing fraudulent security devices for export, including when they are peddled only to foreigners. The SEC generally relies on the first test for jurisdiction abroad, while most lower courts follow these tests or a similar analysis to apply the securities laws extraterritorially.

However, recent Supreme Court decisions may have changed the analysis relied upon for applying any law extraterritorially. The Court now tends to place more emphasis on explicit statutory language and Congressional intent to extend jurisdiction abroad. Yet, in a securities case the Second Circuit has stated, "We freely acknowledge that if we were asked to point to language in the [securities] statute, or even the legislative history, . . . we would be unable to respond."

Finally, we turn to an analysis of the competitive effect on the EEC's financial institutions. Because the financial regulations are similar, under the ISD, an investment services firm would probably be exempt under the Concept Release criteria. However, the EEC credit institution operating pursuant to the Second Directive and the CAD would presumably have a similar competitive advantage over the U.S. bank's foreign operations in the EEC only if the credit institution's combined EEC and U.S. related trading book business (as defined) did not exceed five percent of its total business. Once this threshold is exceeded, the CAD requires the credit institution to operate under the somewhat more restrictive rules of the ISD. Under the Concept Release, the SEC would not require broker-dealer registration unless the total U.S. securities-related revenues

136. Release 15a-6, supra note 50, at 30,015 n.21.
138. Release 15a-6, supra note 50, at 30,015 n.21.
139. GARY B. BORN & DAVID WESTIN, INTERNATIONAL CIVIL LITIGATION IN UNITED STATES COURTS 640 (2d ed. 1992).
140. EEOC v. Arabian Am. Oil Co., 499 U.S. 244, 248 (1991) (court searched for explicit Congressional authorization in applying Title VII extraterritorially to a U.S. employer). However, in an antitrust suit, which employs analysis very similar to that in securities cases to obtain jurisdiction, the Court appeared to give deference to precedent when applying the "conduct or effects" test to London insurers. Hartford Ins. Co. v. Cal., 509 U.S. 764, 795-96.
142. See discussion infra part III.B.
143. See infra notes 154-158 and accompanying text.
exceeded ten percent of its total of such revenues. This threshold was devised as an attempt to reconcile the Concept Release with Regulation K "Qualified Foreign Banking Organization" rules.\textsuperscript{144}

To the extent that an EEC credit institution, otherwise subject to Rule 15a-6, projects that it will remain within the five percent limit, it would be prudent to form an ISD affiliate to prevent the entire credit institution from becoming subject to the jurisdiction of the SEC. If the Concept Release was effective, there would be additional latitude up to ten percent, as the SEC defines securities activities. In any scenario, it is unclear whether the SEC would look to consolidated, combined or individual entities to determine thresholds. Given its "entity" approach to regulation, it currently is likely that it would only look to each separate institution. If the EEC institution is conducting the business out of a branch, the SEC would probably look to combine the branch with the home office for purposes of the test in the Concept Release. This approach is likely, given the direction the Congress has taken with the Market Reform Act, wherein the consolidated entities and intercompany transactional risks are more closely scrutinized.\textsuperscript{145}

\textbf{C. Regulatory Arbitrage Under the EEC Rules}

The EEC directives all approach trading, dealing, brokering, and underwriting activity similarly.\textsuperscript{146} Generally, there is a capital ratio approach with net worth and perhaps subordinated debt as the base from which deductions are made for market and credit risk or illiquid assets.\textsuperscript{147} Recently, U.S. Banks have conformed to this concept, departing further from the reserve method.\textsuperscript{148} Furthermore, the ISD now calls for segregation of customer assets as well.\textsuperscript{149} This concept was almost unique to the U.S..\textsuperscript{150} Finally, the ISD becomes operative on a credit institution, when the institution's banking license permits securities brokerage, underwriting, proprietary trading, or discretionary portfolio

\textsuperscript{144} Trachtman, \textit{supra} note 52, at 280. Discussion of the Board's QFBO rules which regulate the conduct of foreign banks within the United States is outside the scope of this work. However, they also present opportunities for regulatory arbitrage. \textit{Id.}


\textsuperscript{146} Worth, \textit{supra} note 73, at 162-70.

\textsuperscript{147} \textit{Id.} at 140, 147.

\textsuperscript{148} Caesar, \textit{supra} note 110, 1526 & n.8.

\textsuperscript{149} ISD, \textit{supra} note 6, art. 10.

\textsuperscript{150} \textit{See generally} \textsc{The Spicer \\ & Oppenheim Guide}, \textit{supra} note 118.
management.\textsuperscript{151}

To compensate for the various discrepancies in each country's Glass-Steagall-type laws and capital requirements, the directives provide for regulation primarily along functional rather than institutional lines.\textsuperscript{152} For example, proprietary trading by banks will usually be subject to a set of capital rules different from those of credit institutions, which do not significantly partake in such activity.\textsuperscript{153} The host regulators may choose to impose on a credit institution's securities operations, either the Second Directive's capital rules (the "Solvency Ratio") or the ISD's capital rules.\textsuperscript{154} However, this is not entirely elective.\textsuperscript{155} The "election" is only available to firms whose "trading-book business . . . does not normally exceed five percent of . . . total business."\textsuperscript{156} The Solvency Ratio rules are generally more liberal in regard to counterparty and position risks,\textsuperscript{157} which give advantages in underwriting and proprietary trading.\textsuperscript{158} Foreign currency risk is more conservatively treated under the ISD.\textsuperscript{159} Once the ISD rules become operative on a credit institution, selected articles of the ISD also become applicable regardless of the 5% rule.\textsuperscript{160} For example, the credit institution would become subject to prudential controls over customer assets and certain additional reporting requirements.\textsuperscript{161}

\textsuperscript{151} ISD, supra note 6, art. 2.

\textsuperscript{152} CAD, supra note 8. This directive defines "core" activities of banks and securities firms for purposes of the capital adequacy rules. \textit{Id}. To the extent that they overlap, the overlapping activities would be considered "noncore" activities, if the primary purpose of the institution is to offer the core activities. Therefore, it is not clear whether the remainder of the firm's activities would be governed by the ISD or the Second Directive rules as a function of the activities defined in the CAD. See Abrahms, \textit{Financial Services in the New Europe in COMP. L.Y.B. OF INT'L BUS. 320} (D. Campbell & M. Moore eds., 1992).

\textsuperscript{153} CAD, supra note 8.

\textsuperscript{154} COOPERS & LYBRAND, supra note 30, § 1.

\textsuperscript{155} CAD, supra note 8, art. 4 para. 6.

\textsuperscript{156} \textit{Id}.

\textsuperscript{157} Counterparty risk is that risk weight factor generally assigned to a debtor which is usually a function of the type of debtor (e.g., institutional versus individual, taking account of credit ratings, etc.) and concentration of holdings (\textit{i.e.,} how large is the asset in relation to total assets or capital). Position risk is risk weighting assigned to type of financial instruments (\textit{e.g.,} stocks, bonds, certificates of deposit, etc.) and are usually a function of market risk (\textit{i.e.,} volatility). See Haberman, supra note 8, at 4.

\textsuperscript{158} COOPERS & LYBRAND, supra note 30, § 15.4; CAD, supra note 8, art. 2.

\textsuperscript{159} Worth, supra note 73, at 152-3.

\textsuperscript{160} CAD, supra note 8, art. 4 para. 6.

\textsuperscript{161} ISD, supra note 6, art. 2.
However, there is a curious exception to the ISD requirement to segregate customer assets for credit institutions. Consequently, a credit institution conducting an unlimited underwriting and securities brokerage businesses can apparently use brokerage customer assets to finance these and other firm activities. This last concept is at variance with U.S. securities laws and the ISD for investment services firms, as discussed above.

Finally, to avoid further regulatory arbitrage, the percentage thresholds and definitions of securities activities of the directives and Rule 15a-6 must be brought in line. For example, the EEC's CAD rules ignore customer agency transactions and arguably underwriting dealer activity because it only triggers the ISD rules when "trading-book business" exceeds the five percent threshold. Under Rule 15a-6, reference is always made to securities related activities, which have traditionally included agency commissions and thus agency transactions, although its force does not take effect until it exceeded the ten percent threshold.

D. The Universal Bank Quagmire

Another opportunity for regulatory arbitrage is the different treatment afforded universal banks by the EEC, the individual EEC countries, and the U.S. Both the EEC Second Directive and the U.S. banking laws permit limited ownership of non-bank affiliates. Because of the complexity of the Regulation K exception permitting such ownership for U.S. foreign banking institutions, it is beyond the scope of this Note to explore the opportunities for regulatory arbitrage in this context. However, what is clear is that U.S. banks, both home and abroad, may not be owned by non-bank affiliates. Neither the EEC directives nor the German law (as a proxy for universal bank law) prohibit such ownership. However, individual European countries outside of Germany,

162. Id.
163. Id. art. 10.
164. CAD, supra note 8, art. 2 para. 6 (a)-(c). The definition therein of "trading book" includes "proprietary positions" and exposure to unsettled derivative transactions. Id. Included in the definition of proprietary positions are issues "held for resale and/or which are taken on by the institution with the intention of benefiting [from short-term profits]." Id. If the dealer does not participate in the syndicate, and would thereby only benefit from commission revenue, dealer activities would arguably not be included in this definition.
165. SEC Rule 15a-6(b)(3).
166. See discussion infra part II. C. 2.
167. Id.
Austria, and Switzerland have limitations on such ownership.\textsuperscript{168} Therefore, universal banking increases the likelihood of favored loan terms to nonbank affiliates such as industrial concerns and investment services firms. This results in regulatory arbitrage in the sense that those banks not permitted to be owned by nonbank affiliates probably would be shut off from competing to make loans to the parent or other nonbank affiliates.\textsuperscript{169}

However, this perceived disequilibrium may not present as much opportunity as first suspected. For example, a universal bank subsidiary doing business in a nonuniversal bank country under an EEC license may already be lending to its parent’s affiliate; or it could lend to its parent in the universal bank home country and the parent could in turn redirect it to the foreign affiliate. This scenario overlooks any other host country regulations that may prohibit or restrict this activity for prudential reasons.\textsuperscript{170} Because the effects are not as obvious as the ones discussed above, this is an area that probably requires more study to determine the impact, if any, of the EEC Second Directive now permitting universal banking in countries where it never before existed.

IV. THE DIFFERENT APPROACHES TO REFORM

A. Introduction

Most regulations abroad call for reciprocity.\textsuperscript{171} Unlike the U.S. rules, the EEC directives focus on reciprocity rather than prescriptive jurisdiction. They authorize the EEC Commission and Council to ensure that non-EEC members play fair by requiring examination of their conduct. “If, as a result of its reports (or at any other time), the Commission finds that a third country does not grant the Community’s credit [or investment services] institution market access and competitive opportunities comparable to those granted by the Community of third country banks,” the EEC Council and Parliament may restrict, bar,

\textsuperscript{168} Id.

\textsuperscript{169} This may also have antitrust implications. See generally Roe, supra note 69.

\textsuperscript{170} The Second Directive does call for cooperation and coordination of regulation between the home and host country. In addition, the Second Directive also requires that before a financial institution’s stock may be bought “a bank must inform the competent authorities so that their suitability can be appraised.” \textit{European Update}, supra note 4, § 3.3.6.

\textsuperscript{171} See supra note 61 and accompanying text.
suspend or limit the banks from the EEC.\textsuperscript{172}

However, two schemes now in place will make EEC reciprocity difficult. One type of regulation is cross-institutional (e.g., Glass-Steagall and BHCA), and the other is cross-functional (e.g. custody of customer assets in securities activities).\textsuperscript{173}

\textbf{B. A Recent U.S. Banking Amendment}

One recent effort to lower barriers to U.S. banks’ entry into the securities business was the Senate Finance Committee’s unsuccessful proposals for the Improvement Act.\textsuperscript{174} The Improvement Act had some of its origins in a Presidential initiative to repeal Glass-Steagall, to amend the BHCA accordingly, and to permit more interstate branching by amending the McFadden Act.\textsuperscript{175} The underlying premise was that, given extreme competition from the securities industry, foreign entities, and mutual funds, banks were forced to enter into risky loan business to try to compensate for lost revenues.\textsuperscript{176} Eliminating barriers to investment banking and securities brokering would enable the banks to compete and to recover their lost profit margins with very little downside risk, as proposed by the Senate Bill.\textsuperscript{177}

However, by the time the bill got through the House, reform had turned to retrenchment. The law, as passed, strengthens barriers to the securities industry,\textsuperscript{178} removes compensation schemes for purely foreign business,\textsuperscript{179} and restricts access further for foreign financial institutions doing business in the United States.\textsuperscript{180} All this comes at a time when Europe is succeeding in creating a uniform financial services market.\textsuperscript{181}

\begin{footnotes}
\footnotetext[172]{Second Directive, supra note 3, art. 9 § 3.}
\footnotetext[173]{See supra notes 74 & 102 and accompanying texts.}
\footnotetext[175]{The Bush Administration tried unsuccessfully to repeal the McFadden Act. See id. at 61 et seq. In contrast to the theme of the First and Second Banking Directives, U.S. banking laws substantially prohibit interstate branching of banks. National Banking Act, 12 U.S.C. § 36 (referred to as the McFadden Act).}
\footnotetext[176]{S. REP. No. 167, supra note 174, at 28.}
\footnotetext[177]{Id. at 142-57.}
\footnotetext[178]{Improvement Act § 207.}
\footnotetext[179]{Id. § 312.}
\footnotetext[180]{Id. §§ 202-206.}
\footnotetext[181]{First Directive, supra note 3, pmbl.}
\end{footnotes}
Instead of looking to the securities industry for methods of protecting customers, the main thrust of the Improvement Act was to provide the depleted FDIC fund with additional borrowing capacity. 182

The prudential controls called for in the Improvement Act are enhancement through additional auditing, reporting, and accounting requirements. 183 The Improvement Act also calls for additional federal oversight of multi-state foreign branches and banks because an "individual state does not have the authority to ensure that the multi-state operations are properly supervised." 184 Finally, the Improvement Act prohibits the insurance of foreign deposits by the FDIC. 185

President Bush, while signing the law, expressed disappointment that his version did not go through: "[My] proposal equally addressed the fundamental problems of the banking industry . . . Unfortunately, the narrow legislation produced by Congress does little more than provide critical funding to the Bank Insurance Fund." 186 In accord with President Bush's proposal, the Senate Committee recommended the repeal of Glass-Steagall:

In retrospect, the more fundamental reforms growing out of the financial crisis of the 1930[s], such as the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the strengthening of the Federal Reserve Act . . . [have] stood the test of time and practice. The Glass-Steagall separation does not appear to have been an essential component . . . [of the reform]. 187

However, the committee's recommendations go on to construct "fire walls," prohibit extension of credit to securities affiliates for underwriting activities, and require separate customer compensation schemes. 188 The proposal seemed nothing more than an expedient way to infuse much


183. Improvement Act §§ 100-112.


185. Id. at 1909.

186. Bush, supra note 182, at 1649.


188. Id. at 528.
needed capital into the banking industry at the expense of the securities industry. With the FDIC compensation scheme intact, which is not a deterrent for the industry as a whole, banks would still be able to engage in risky commercial or foreign lending. As the Senate Report so pointedly stated, "Securities affiliates must absorb their losses with their own capital. They will not be kept afloat . . . . They must bear their own risks for their investment decisions and compete in the market place." 

Securities broker-dealers do these things now. What benefit would they derive from this proposal? Furthermore, unlike the industry-funded compensation scheme of the securities business, bank risks are born by the taxpayer. Thus, the taxpayer would have made out better if he bailed out all the SIPC liquidations in the past 20 years, as compared to FDIC payouts over the same period. A U.S. bias that permeates not only the

189. The Improvement Act enhanced certain prudential controls; however, it did little to address the underlying cause of bank failures such as the competition from other industries and institutions abroad. The Senate Report noted these concerns, but that version of the President's bill was not passed. S. REP. No. 167, supra note 174.

190. Id. at 158.

191. Securities broker-dealers' assets are generally self-funding. Most of the assets are readily marketable and thus provide for collateralized financing with banks, broker-dealers and other institutional lenders. However, to the extent that they require unsecured borrowings such as bank loans or issuance of commercial paper, there is systemic risk that would extend to the banking community as well. This legislation was primarily the result of the collapse of Drexel Burnham Lambert Group, Inc. See H.R. REP. No. 524, 101st Cong., 1st Sess. 8 (1990), reprinted in 1990 U.S.C.C.A.N. 1449 (legislative history to the Market Reform Act).


193. See Ceasar, supra note 110, n.11 (the FDIC has paid out over $15 billion since its inception). The FSLIC has paid out over $500 billion, most of it in the past decade. For the 24 years ended December 31, 1994, the total distribution for the accounts of customers was less than $2 billion. SECURITIES INVESTOR PROTECTION CORPORATION, TWENTY-FOURTH ANNUAL REPORT OF THE SECURITIES INVESTOR PROTECTION CORPORATION app. I (1995) [hereinafter SIPC Annual Report].
legislature, but also academia, is that the nature of the securities business is inherently riskier than commercial banking. If risk is measured by the amount of funds customers have lost in relation to their deposits or investments, this is simply not the case. Given the nature of banking protection both here and abroad, taxpayers frequently pay for protected depositors’ balances. However, under the U.S. securities laws, before SIPC pays, SEC Rule 15c3-3 allows for the self-liquidation or transfer of customer balances without the necessity of bankruptcy proceedings.

As one commentator noted, "[T]he recent Treasury Report considers enhanced capital standards and supervision as almost a universal solvent for banking ills as a means to insure against many of the risks in the system." As the Improvement Act demonstrates, the other fix-it is government-backed insurance.

C. Constraining U.S. Securities Broker-Dealer Regulation

Securities regulators use both belts and suspenders. The products (securities) are highly regulated through both the 1933 Act and the 1934 Act. Customers receive so much information on a publicly traded

194. Certainly not empirically.
195. "In principle, banks and securities firms serve two distinctly different functions. Banks are viewed as quasi-public institutions. . . . In contrast, securities firms are risk-taking institutions. . . . In practice, the line between securities firms and banks is considerably less distinct . . . ." Worth, supra note 79, at 136-140; but see Haberman, supra note 8, at 2 n.1 (author argues that the differences between the two are fundamental, since the time horizons regarding risk profiles are significant). Thus, broker/dealer capital standards and accounting reflect liquidation values, as time horizons are short, whereas commercial lending capital standards reflect going concern risks and accounting. However, the author seems to conclude that the two industries are becoming more and more alike in the kinds of risks they undertake. See also Richard Dale, Regulating Banks’ Securities Activities: A Global Assessment, J. OF INT’L. SEC. MKTS., Winter 1991, at 287-88 (usual analysis involving “fire walls” between the different functions).

196. See supra note 168 and accompanying text.
197. Id.
198. H.R. REP. NO. 524, supra note 191, at 1462-64.
199. Caesar, supra note 110, at 1528.
200. Id. at n.22.
201. Not only are the institutions that sell, distribute and underwrite securities subject to extensive regulation under the 1934 Act and 1933 Act, but so are the issuers, who are subject to periodic and special reporting requirements such as annual and quarterly financial statements and proxy reports. Richard W. Jennings et al., Securities Regulation 151-85 (7th ed. 1992).
that they probably do not read very much of it. The activities of brokerage firms are subject to the most complex capital rules in the world, where even the regional stock exchanges and associations promulgate and enforce financial and operational controls. Customer assets are safeguarded by an entire range of quasi-industry type insurance schemes, while customer-owned assets are fully segregated. With insurance and Rule 15c3-3, net capital becomes redundant to a broker-dealer, at least so far as customers are concerned. Of course, lenders and other noncustomer creditors are certainly entitled to protection too, at the very least to avoid or mitigate systemic catastrophes.

What is even more difficult to reconcile is the fact that customers of broker-dealers decide in what they are investing or to whom they are lending their money by purchasing the stocks, bonds, and mutual funds of their choice. In contrast, bank depositors generally have no idea where their money is invested, as this is decided entirely by the bank. If customers of broker-dealers are choosing their own credit and market risks, why should they be more protected than depositors who have no say as to where their money goes? Both institutions are really nothing more than financial intermediaries, and as discussed earlier, the ultimate risk bearer for the bank is the federal government, while this is not the case with the securities industry.

However, as the FDIC is almost depleted, SIPC has been overfunded to the point where it has ceased assessing its members for almost five years. The entire blame for this result does not lie with Congress.

202. *Id.* at 151-2.

203. All SEC registered broker-dealers must also become members of the National Association of Securities Dealers, and of every securities and commodities exchange on which they trade. For a large securities and commodities dealer this could well involve over a dozen regulators, each with its own set of rules. JENNINGS, *supra* note 201, at 562-70.

204. Broker-dealers are not only covered by SIPC, but generally purchase through private insurance carriers multi-million dollar blanket-bond insurance. In addition, under Rule 15c3-3, broker-dealers must segregate net customer assets and otherwise not employ any customer assets in proprietary business. 17 C.F.R. § 240.15c3-3.

205. Insurance and the protection guaranteed by Rule 15c3-3 generally would fully cover customers of a broker-dealer only. Net capital should thus be protection for all other creditors such as banks, other broker-dealers and commercial paper holders. For arguments in favor of controlling systemic risk, see H.R. REP. No. 524, *supra* note 191.

206. Haberman, *supra* note 8, at 2 n.1 (i.e., vehicles that match up borrowers or capital users of money, with lenders or investors.)

207. Assessments were resumed in 1989-90. SIPC ANNUAL REPORT, *supra* note 193, at 9.
Great deference has been given to the SEC and the Federal Reserve Bank regulators; in fact, in some cases, regulations appear to exceed Congressional intent. For example, neither the 1934 Act nor the Securities Investor Protection Act of 1970 ("SIPA") prohibits the use of customer assets in firm business.\textsuperscript{208} In fact, complete segregation of customer assets did not occur until after the enactment of the rule in 1973.\textsuperscript{209}

The SEC justifies the 1973 rule on many bases. First, Congress became concerned with the failure of broker-dealers in the late 1960s.\textsuperscript{210} During this period, as a result of an increase in stock exchange volume, some brokerage houses lost control of their recordkeeping regarding which assets belonged to the firm and which belonged to the customers.\textsuperscript{211} It should be recalled that during this period, the largest firms had neither automated records nor centralized securities processing and depositories.\textsuperscript{212} Even before the crisis, the industry attempted to protect customers by setting up exchange-sponsored trust funds,\textsuperscript{213} but these soon proved inadequate.\textsuperscript{214}

Congress responded with overregulation, amended the 1934 Act, and enacted the SIPA.\textsuperscript{215} Congress recognized that "free credit balances are funds left with a broker-dealer firm by customers who have an unrestricted right to withdraw them on demand . . . but [nonetheless] may be and are

\textsuperscript{208} Section 15(c)(3) of the 1934 Act comes the closest to requiring segregation, and certainly does not seem to mandate 100% reserves of net customer assets: "Such rules and regulations shall (A) require the maintenance of reserves with respect to customer deposits or credit balances . . . ." Similarly, the SIPA Congress defers to the above, and simply states, "The Commission [is] . . . to promulgate rules with respect to . . . the carrying and use of customer deposits or credit balances." H.R. REP. No. 1613, 91st Cong., 2nd Sess. (1970), reprinted in 1970 U.S.C.C.A.N. 5254.


\textsuperscript{210} H.R. No. 1613, supra note 208, at 5255.

\textsuperscript{211} Id. at 5255.

\textsuperscript{212} Id. All records were prepared manually and all certificates were in physical form. Large volume meant tremendous volumes of paper were necessary to transfer securities. \textit{Id.}

\textsuperscript{213} \textit{Id.} at 5256.

\textsuperscript{214} \textit{Id.} at 5265-66.

\textsuperscript{215} The Senate Finance Committee noted much later that Congressional reaction to a crisis usually involves over legislating. For example, they point out that as a result of the 1929 stock market crash and the ensuing bank failures, Congress reacted with a wave of legislation, but the only two they now consider necessary were the Securities Acts and the FDIC Act. S. REP. No. 167, supra note 174, at 149.
used by broker-dealers [for any proprietary purpose]."216 Although Congress did not affirmatively mandate that free credit balances be segregated, it did authorize the SEC to promulgate regulations in regard to them.217 Free credit balances in 1970 and 1969 were estimated at $2.0 billion and $3.7 billion, respectively.218 Through the enactment of Rule 15c3-3, the SEC reduced the money supply overnight.219 However, Congress was more concerned with the use of customer securities. Through amendments to the 1934 Act, it prohibited the use of fully paid for or excess margin securities in firm business without the customer’s written consent.220 The greater concern with securities than with cash is not easily explainable. It probably has more to do with a lack of understanding of the way securities are accounted for and deployed by the firm, rather than any concern over how they are treated in bankruptcy or whether they are prone to conversion more so than cash.221 Nevertheless, the SEC rule amendments require that all such securities be reduced to “possession or control” within twenty-four hours with certain limited exceptions.222 In the U.S., banks are subject to rules identical to those applied to broker-dealers based on a functional analysis per the 1934 Act. However, per the BHCA, broker-dealer activities must be performed in a separate affiliate of a bank holding company.223 The SEC, however, would in substance have primary jurisdiction over the securities affiliate.224

216. H.R. No. 1613, supra note 208, at 5255.
217. Id. at 5256.
218. Id. at 5255.
219. By requiring that free credit balances be segregated, firms no longer could use those monies to finance proprietary activities. Thus, to the extent broker-dealers had to increase borrowing, the money supply was reduced. Arguably, to the extent that the overall financing requirements of the firm and customers did not change (since money is fungible), the money supply would be unaffected. However, given that most broker-dealers have net customer assets, which would require a deposit requirement, the latter conclusion is unlikely.
221. For an extensive discussion of the bankruptcy implications of a SIPC liquidation in regard to bulk segregation of securities, see Charles W. Mooney, Jr., Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries, 12 CARDOZO L. REV. 305 (1993).
222. SEC Rule 15c3-3(d), 17 C.F.R. § 240.15c3-3(d) (1993).
223. See supra note 81 and accompanying text.
224. Under § 12(i) of the 1934 Act, 15 U.S.C. § 78l (1994), and the Bank Holding Company Act, banking regulators appear to have primary jurisdiction. However, the SEC maintains that it has such, and the Federal Reserve seems to have acquiesced. See, e.g., Office of the Comptroller of the Currency Regulations, 12 C.F.R. §§ 5, 11, 16 (1993)
Finally, at the same time that it issued Rule 15a-6, the SEC also asked for comments on recognition of foreign regulation for foreign entities activities abroad (the Concept Release).\textsuperscript{225} This endeavor has apparently been put on hold, as no regulation recognizing foreign requirements has since been issued.\textsuperscript{226} The SEC made it clear that the Concept Release was not advocating a reciprocity approach. If the foreign broker-dealer fell within the prescriptive jurisdiction of the U.S. regulatory scheme, it would remain subject to the SEC registration requirements, unless otherwise exempt. Furthermore, the conditional exemption is not applicable to any foreign broker-dealer which has a U.S. broker-dealer affiliate. In fact, the Concept Release appears to do little more than parallel Rule 15a-6:

The SEC believes that a cooperative approach to the regulation of a foreign broker-dealer conducting a limited business from outside the United States with major U.S. institutional investors deserves serious consideration . . . [b]y relying in certain limited circumstances on comparable foreign regulation as a substitute for U.S. regulation . . . .\textsuperscript{227}

Although the Concept Release appeared to be the first step toward reciprocity,\textsuperscript{228} the approach taken in Rule 15a-6, disproves this perception.\textsuperscript{229}


Most European countries do not draw such fine distinctions between banks and broker-dealers—e.g., “Germany’s present structure is characterized by a universal banking system with a broad banking definition. Virtually every security-dealing activity is classified as banking and requires a banking license under German law.” Gerhard Wegen, Transnational Financial Services—Current Challenges for an Integrated Europe, 60 F O R D H A M L. REV. S91, S103 (1992).

The EEC Directives provide for overlapping activities as well. CAD, supra note 8; see also supra note 152.

225. See supra note 68 and accompanying text.


228. Trachtman, supra note 52, at 279-80.

229. See supra notes 67- 69 and accompanying text.)
D. The EEC’s Uniform License and Reciprocity Approach

Putting aside issues of proof and enforcement, the reciprocity approach could logically and should inevitably lead to a race to the bottom. For example, if a German universal bank, which under German law is permitted to conduct practically all of the Annex 1 activities under German law, decides to open shop in a country that prohibits or limits universal banking, it may have a competitive advantage over the host countries’ domestic financial institutions.230

In the previous example, what would be the incentive for the host country not to amend its regulations to be more consistent with German law? As one author has observed, “[The] potential for regulatory arbitrage is expected to cause laws and regulations throughout the Member States to converge toward the list of permissible activities contained in the Annex.”231 The host country that is less permissive than the home state runs the risk of allowing its own financial institution to be at a competitive disadvantage and perhaps become a no-longer viable concern.

Others have observed that “adherents to this concept generally ignore historical precedent. The New York and London markets have emerged as the largest international markets despite having the two most comprehensive securities regulatory systems in the world.”232 However, this phenomenon probably has more to do with where technology and certain populations are centered, rather than with indifference to regulation. Others argue that EEC firms will not seek regulatory arbitrage opportunities because “domestic EC institutions would [not] relinquish decades (if not centuries) of accumulated administrative and political voice in their Home state for anticipated benefits from other jurisdictions.”233 But this reasoning overlooks the speed with which financial markets change.234 Only the agile survive in rapidly changing markets. Another argument made is that because the financial standards are uniform under

230. See discussion supra part III. C.
233. Matthews, supra note 114, at 95.
234. The market in cross-border offerings of bonds, including foreign and Eurobonds, expanded from $38 billion in 1980 to $238 billion in 1988. The value of equity-related securities offered to investors in markets outside the issuers’ home state grew from $200 million in 1983 to 20.3 billion in 1987 . . . [and although foreign purchases of U.S. securities grew at a fast clip] . . . United States gross purchases and sales of foreign debt and equity securities grew from $35.2 billion and $17.9 billion in 1980 to $405.9 billion and $189.4 billion, respectively in 1987. Warren, supra note 113 at 1.
the EEC directives, this will mitigate the effects of regulatory arbitrage.\textsuperscript{235} But as discussed earlier, this is only true at least to the extent that there is no cross-institutional arbitrage through the establishment of different legal entities under the ISD and Second Directive for similar businesses.\textsuperscript{236}

Finally, two other opportunities exist as a result of the directives’ reciprocity provision itself. The provision provides that all EEC member states \textit{act in unison} to bar non-member firms unless the non-member state gives all EEC members reciprocal treatment.\textsuperscript{237} This could have monopolistic effects both within the Community for firms that are not following the Directives and with other third country financial institutions. In addition, because of the grandfathering of legal entities that already have a license in an EEC state prior to the effective date of the directives, branches of these firms should incorporate prior to such date.\textsuperscript{238} Otherwise, they will be subject to the host countries’ laws or not permitted to remain. However, being subject to the host country’s laws in some cases could be beneficial as discussed earlier.\textsuperscript{239}

\section*{V. Conclusion}

As one commentator indicated, the logical effect of the EEC directives is for financial conglomerates and universal banking to become commonplace in Europe.\textsuperscript{240} This is at a time when the U.S. regulators appear to be retrenching and, in some cases, proposing rules that would increase regulatory arbitrage. This may result in a protectionist reaction by the EEC.\textsuperscript{241}

If Europe is to seriously consider recommendations for a framework almost identical to that of the U.S., it must examine further whether that framework has indeed worked in the U.S. It should also examine what its experiences have been with regard to its own institutions. Finally, it should be noted that U.S. rules have been difficult to work with and

\begin{itemize}
\item \textsuperscript{235} Mathews, \textit{supra} note 114, at 96.
\item \textsuperscript{236} \textit{See} discussion \textit{supra} part III C.
\item \textsuperscript{237} Second Directive, \textit{supra} note 3, pmbl.; ISD, \textit{supra} note 6, art. 6
\item \textsuperscript{238} Warren, \textit{supra} note 113, at 203.
\item \textsuperscript{239} For example, a foreign bank doing business as a branch of a nonuniversal bank country may prefer to remain subject to the nonuniversal bank country’s jurisdiction rather than the EEC’s directives. See discussion \textit{supra} part III. C.
\item \textsuperscript{240} Jan Schuijer, \textit{Banks Under Stress; Analysis of Recent Developments in Banking}, OECD Observer, Dec. 1991, at 19.
\item \textsuperscript{241} Brittan, \textit{supra} note 79.
\end{itemize}
overly complex.\textsuperscript{242}

As a first step, the best alternative to existing schemes, both in Europe and in the U.S., is to amend Glass-Steagall-type barriers.\textsuperscript{243} This could be achieved by extending the SEC's customer segregation requirements to bank deposits held in the resulting financial conglomerates, while "reserving" a percentage of these assets at an amount greater than the current insignificant percentages but less than the 100\% required under the securities laws. This framework could, of course, be supplemented by capital adequacy guidelines, industry insurance and guarantee funds, and maintenance of custody rules for trust departments. The greater challenge would be to move toward universal banking. However, even in the EEC, universal banking is not commonplace. The effects of permitting universal banking worldwide probably should be examined further as this particular race to the bottom could be deleterious for the same reasons the BHCA was passed in the U.S.

With rapid globalization of the financial markets, measured deregulation, jurisdiction by jurisdiction, may be cumbersome. An international commission similar to the EEC's that has legislative and enforcement authority greater than the present voluntary organizations such as the Basle Accord and IOSCO appears to be necessary.\textsuperscript{244} Harmonization of the rules and coordination of surveillance and enforcement appears to be the only solution. Otherwise, there will be the search for the least restrictive, lowest cost means to execute identical transactions in the same market. Jurisdictional conflicts will inevitably result. In the meantime, whether by design or default, there are opportunities within the EEC market for regulatory arbitrage in the securities area. These opportunities depend upon whether the form of the financial institution is a bank or securities broker-dealer and which regulator has jurisdiction.

\textit{Frederick W. Gerkens}


\textsuperscript{243} See supra notes 75-86 & 93-103 and accompanying text.

\textsuperscript{244} See Warren, supra note 113, at 189 n.21.