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THE FOREIGN BANK EXEMPTION TO THE SARBANES-OXLEY PROHIBITION ON LOANS TO DIRECTORS AND OFFICERS

By: Dina Colon

Introduction

In the wake of the collapse of Enron and other major scandals which plagued the U.S. business world, Congress passed the Sarbanes-Oxley Act (the “Act” or “SOX”) in July 2002 in an effort to combat corporate abuses. As part of the effort to thwart abuses by corporate insiders, § 402 of the Act provided for a “prohibition on personal loans to executives” in recognition of the fact that at many of the corporations involved in the scandals, officers and directors were appropriating corporate funds in the form of loans. For instance, during 2001 and 2002, Adelphia made loans amounting to over $263 million to the Rigas Family, including the chief executive officer of the company, John Rigas and WorldCom made loans amounting to over $160 million to the companies’ former chief executive officer, Bernard Ebbers. In February 2003, Senator Levin noted:

“Section 402 has put an end to a large set of abuses associated with company loans to executives. They include loans issued without interest; loans used to build personal mansions at company expense; loans used to provide executives’ families with tax-free insurance benefits; loans for every purpose and loans that are never repaid. Company funds belong to shareholders and are intended to benefit them and the company they own; they were never intended to act as a pool of funds available to be loaned or given to company executives.”

U.S. banking institutions were granted an exemption to § 402 provided that (i) such institution’s deposits were insured by the Federal Deposit Insurance Corporation (“FDIC”) and (ii) the institution was subject to insider lending restrictions under the

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Federal Reserve Act. Based on the limitations, foreign banking institutions listed on U.S. markets were not eligible for such exemption. These institutions were angered by what they perceived as an “uneven playing field” with their U.S. counterparts and urged regulators to extend the exemption to foreign banks as well. The Securities and Exchange Commission (“SEC”) responded to such request and adopted a rule (“Rule 13k-1” or the “rule”) in April 2004 that provided an “exemption from the insider lending prohibition” enumerated in § 402 to foreign banking institutions that complied with certain conditions specified in the rule. First, this note will examine the historical background of U.S. regulation of (i) loans to executives and directors as well as the problems associated with such loans and (ii) foreign issuers listed on U.S. markets. Second, this note will look at SOX, particularly § 402, in the context of its legislative intent, the consequences of such law and its impact on foreign issuers, particularly foreign banking institutions. Finally, it will analyze Rule 13k-1 which extended the exemption to foreign banks, its requisite conditions, the implications of such exemption to foreign banks and examine whether such conditions are suitable in the context of the regulatory framework of several foreign nations, including Great Britain, France, Canada and Australia, with respect to banking institutions.

Historical Regulation of Loans to Executives and Directors

Historically, the only corporations that enjoyed “the right to engage in making loans as a business [were those] organized for that purpose.” Notwithstanding such restriction, corporations enjoyed an incidental right to make loans (i) “which further[ed] the corporate interests and advance[ed] and promote[d] the objects for which the corporation was organized” or (ii) unless expressly prohibited, temporarily loaning surplus cash that would have otherwise remained unproductive. At common law, “[i]t was not inherently wrong for the surplus funds of a corporation to be loans to its officers or directors, in the absence of fraud.”

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11 6 Fletcher Cyclopaedia of the Law of Private Corp. § 2619 (2005). The restriction on lending “was later modified by the recognition that a business sometimes had to lend money, or extend credit to its customers, in order to succeed in the marketplace.” Jayne W. Barnard, Corporate Loans to Directors and Officers: Every Business Now A Bank?, 1988 WIS. L. REV. 237, 241 (1988).
12 Id. Such power is “generally conferred on the corporation by statute, unless its articles of incorporation provide otherwise.” 6 Fletcher Cyclopaedia of the Law of Private Corp. § 2619 (2005).
14 6 Fletcher Cyclopaedia of the Law of Private Corp. § 2622.10 (2005). The MODEL BUS. CORP ACT § 47 (1969) provided that “[a] corporation shall not lend money to or use its credit to assist its directors without authorization in the particular case by its shareholders, but may lend money to and use its credit to assist any employee of the corporation or of a subsidiary, including any such employee who is a director of the corporation. If the board of directors decides that such loan or assistance may benefit the corporation.”
Prior to the enactment of SOX, all public companies had to disclose loans, in excess of $60,000, to executive officers and directors in annual filings to the SEC.15 Most states also have adopted statutes that regulate or prohibit loans to officers and directors.16 In the context of banking institutions, statutes regulating or prohibiting loans by banking institutions to officers and directors have been enacted in response to bank failures triggered by “overborrowing of bank funds by directors, officers, agents, employees or stockholders.”17 Some of these statutes place limits on loans to insiders or enumerate conditions under which such loans may be provided, such as board approval.18 In order to be subject to penalties under certain statutes, the corporation must knowingly violate the statute, however, other statutes require no such intent.19 In case law interpreting a statute which prohibited loans to directors, the court noted that the underlying purpose for restrictions on loans to insiders was to “protect stockholders, depositors, and creditors of the bank against the temptation to which the directors and officers might be exposed and from the power which they must necessarily possess in the control and management of the bank.”20

Companies began offering loans to insiders several decades ago in order to assist new executives relocating to expensive areas.21 In the late 1980s, companies began extending such loans in connection with stock-purchase loan programs.22 By the late 1990s, loans to insiders became a “key facet” to executive compensation packages.23 Prior to SOX, a loan to officers and directors was a common practice.24 In December 2002, The Corporate Library, an independent research firm, published “My Big Fat Corporate Loan” which assessed the prevalence of such loans.25 The report found that one-third or 1,500 of the largest U.S. corporations loaned money to executives and the average size of such loan, with respect to the 416 companies disclosing actual loan amounts, was $10.7 million with the total amount loaned by such corporations at $4.5 billion.26 The report also found, with respect to the 409 companies that reported the

15 17 C.F.R. § 229.404 (c) (2004).
16 Barnard, supra note 11, at 237. Four states prohibited such loans, six states required shareholder approval. twenty nine states required board approval and eight states had no restrictions on loans to officers and directors. Id. at 238-239.
17 Ferdinand S. Tinio. Construction and Application of Statutes Prohibiting or Limiting Loans to Bank Officers or Directors, 49 A.L.R. 3d 727, *2a. Such statutes are in addition to Regulation O, a compilation of federal laws and regulations relating to restrictions on domestic banks ability to make loans to insiders.
18 Id.
19 Id. But See 6 Fletcher Cyclopedia of the Law of Private Corp. § 2623 (2005): “A bank is charged with knowledge of a statute prohibiting corporations from lending money to its officers[.]” 6 Fletcher Cyclopedia of the Law of Private Corp. § 2623 (2005).
20 Tinio, supra note 17, at *3 citing Lester v. Howard Bank, 33 Md. 558 (1871).
22 Id.
23 Id.
24 Id.
26 Id. Congressional records further highlight the significant amount of corporate funds loaned to executives. Wachovia had loaned $2.2 billion to executives, Adelphia loaned $263 million to the Rigas family who owned the company, Worldcom loaned its CEO $160 million and Kmart loaned

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number of loans made to officers and directors, on average each company had six loans to insiders outstanding and the total number of such loans outstanding at the time of the report was 2,451.\textsuperscript{27} The report further found that companies were issuing substantial loans to executives on terms that disadvantaged the company and on terms more beneficial than those offered to the public.\textsuperscript{28} Only 53.7% of the corporations lending money to executives required the payment of interest.\textsuperscript{29} Other corporations charged below market interest rates on loans to executives.\textsuperscript{30} "The report also identified over 100 companies that had, or were in the process of forgiving loans to their executives."\textsuperscript{31} Thirteen companies reported that forgiven loans would be grossed up for tax purposes in order for the company to pay the executive's tax on such income as well.\textsuperscript{32} The report showed that the majority of loans to executives were furnished for the purpose of buying stock in the corporation and the second most common type of loans were provided for relocation purposes, including home purchases.\textsuperscript{33} The third most common type of loan reported was for unspecified reasons or reasons not disclosed to shareholders.\textsuperscript{34} A number of loans were for purposes unrelated to business such as cash advances, personal loans and insurance premiums payments.\textsuperscript{35}

In light of the prevalence of such loans, it seems inevitable that such practice would be subject to abuses. Such abuses are particularly disconcerting in the context of poorly performing companies. For instance, Kenneth Lay, former chairman and chief executive officer of Enron used his corporate line of credit to take $77 million in cash at a time when Enron was suffering a cash shortage and subsequently failed to repay $7

\textsuperscript{27} Paul Hodgson, My Big Fat Corporate Loan (The Corporate Library) December 2002, at 1. \textit{available at} \url{http://www.business2.com/b2/web/articles/0,17863,515097,00.html} (last visited March 10, 2005). "Six companies, among them Bear Sterns, Raymond James Financial. Tyco International. and Franklin Covey, had each made over 100 loans." \textit{Id.}

\textsuperscript{28} 149 Cong. Rec. S 2178, s 2179 (daily ed. February 11, 2003) (statement of Sen. Levin), LEXIS 149 CONG. REC. S. 2178*2179. President Bush, who called on public companies to self impose a ban on loans to officers in July 2002, accepted two loans amounting to $180,375 from Harkin Energy Corp. while he was a director of Harkin. The loans were given for the purchase of company stock and made at a below market interest rate. Mike Allen. \textit{Bush Took Oil Firm’s Loans as Director}. WASH. POST. July 11, 2002 \textit{available at} Westlaw. Sathates-Oxley Act Legislative History 41-E. WL 32054482.

\textsuperscript{29} Paul Hodgson, My Big Fat Corporate Loan (The Corporate Library) December 2002, at 1. \textit{available at} \url{http://www.business2.com/b2/web/articles/0,17863,515097,00.html} (last visited March 10, 2005). "Six companies, among them Bear Sterns, Raymond James Financial. Tyco International. and Franklin Covey, had each made over 100 loans." \textit{Id.}


\textsuperscript{31} Paul Hodgson, My Big Fat Corporate Loan (The Corporate Library) December 2002, at 2. \textit{available at} \url{http://www.business2.com/b2/web/articles/0,17863,515097,00.html} (last visited March 10, 2005). One quarter of the companies reported making interest free loans and one quarter reported making loans that were not required to be repaid at all. \textit{Id.}


\textsuperscript{33} \textit{Id.}

\textsuperscript{34} \textit{Id.}

\textsuperscript{35} \textit{Id.}

\textsuperscript{36} \textit{Id.}

\textsuperscript{37} Paul Hodgson, My Big Fat Corporate Loan (The Corporate Library) December 2002, at 2. \textit{available at} \url{http://www.business2.com/b2/web/articles/0,17863,515097,00.html} (last visited March 10, 2005).

\textsuperscript{38} \textit{Id.} at 3.

\textsuperscript{39} \textit{Id.}

\textsuperscript{40} Paul Hodgson. My Big Fat Corporate Loan (The Corporate Library) December 2002, at 4. \textit{available at} \url{http://www.business2.com/b2/web/articles/0,17863,515097,00.html} (last visited March 10, 2005).
million of the $81 million he borrowed in 2001. In the midst of bankruptcy, Kmart forgave two retention loans to two former executives which cost the company $7 million dollars. While the prevalence, beneficial terms and abuse of insider loans certainly affects the profitability of public companies “the more damaging legacy may be that the practice- by helping fuel the explosion in CEO pay that is at the heart of much of today’s outcry over corporate behavior- will contribute to the perception that management has all too often lined its pockets at investors’ expense, and to the public’s distrust of how American companies are run.”

Loans to insiders are of particular concern in the context of banking institutions in light of the ramifications of abuse in the industry.

“In 1994, the U.S. Government Accounting Office (GAO) published a report that reviewed information from banks which failed in 1990 and 1991. Of the 286 cases investigated, 175 had identifiable insider problems. Of these, seventy-four or 26% had major insider problems. Fraud was the most cited form of insider abuse, which was found in 104 of the 175 banks with any insider problems. In particular, insider abuse existed in 117 cases while loan losses to insiders were revealed in eighty-one banks.”

Violations of insider lending restrictions pursuant to Regulation O were also found at 82 banks with total of 148 violations. The GAO report also found that loans on preferential terms were made at 70 banks with a total of 103 violations. Another study of over 9,000 banks illustrated that, where banking institutions loaned more than 25% of its funds to insiders, it was 4 times more likely to fail and that the 5 banks with the

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39 Catharine M. Lemieux, Conglomerates, Connected Lending and Prudential Standards: Lessons Learned. 4 UCLA J. INT’L & FOREIGN AFF. 149, 157-158 (1999). In the late 1980’s a number of banks and savings and loan failures were substantially attributed to excessive loans to insiders. For instance, Vernon Savings & Loan, Old Court Savings & Loan, Merritt Commercial Savings & Loan, United American Bank, Commonwealth Savings, FirstSouth FSB, Penn Square Bank and Alaska Teamster’s Federal Credit Union. Barnard, supra note 11, at 269.
40 Lemieux, supra note 39, at 158. The GAO report also identified factors associated with such violations. For instance, where banks violated lending limits to insiders, examiners were 4 times more likely to criticize the bank for dominating board members. With respect to violations for failure to obtain board approval of loans to insiders, examiners where 7 times more likely to condemn the board for lack of expertise. Id. at 159. “[I]t appears that directors of some banks seem not to have understood their role and responsibilities in maintaining or returning the bank to a financially sound position.” GAO Report. Bank Insider Activities. Insider Problems and Violations Indicate Broader Management Deficiencies, GAO/GGD 94-88, 1994 WL 833308 (March 30, 1994).
41 Lemieux, supra note 39, at 158.
highest ratio of insider loans to total equity in 1986 all failed. Given the government’s interest in avoiding bank failures and subsequent government bail out, banks are highly regulated with respect to insider lending, but nonetheless can be subject to abuse. In light of public concern over corporate abuses and the pervasiveness of loans to corporate insiders it was inevitable that it was merely a matter of time before such heavy regulations were imposed on all public companies.

**Historical Regulation of Foreign Corporations Listed on U.S. Markets**

Historically, regulations imposed on public companies listed in the U.S. were not strictly imposed on foreign issuers listed in the U.S. markets. From its earliest days, the SEC has worked to accommodate foreign issuers, and to facilitate their access to [U.S.] markets...one year after the SEC’s creation, the Commission issued a rule exempting foreign companies from our rules governing both proxy statements and reports by insiders of transactions in their companies securities. The New York Stock Exchange (”NYSE”) also provided such accommodation in its compliance manual which provides that “compliance with home country governance would suffice.” The underlying rational was that foreign officials, supervising foreign issuers domiciled in its jurisdiction, were capable of ensuring adequate shareholder protection. It is also a reflection of the fact that such regulation is a product of each country’s economic and legal culture. Such accommodations, which enabled foreign issuers to list in the U.S without strictly adhering to all U.S. regulations, has led to over 1,300 foreign companies opting to list in the U.S. with U.S. citizens owning $1.5 trillion in foreign stock. Given the number of foreign issuers and the tremendous amount of U.S. money invested in foreign corporations, accommodating such corporations is an important goal for lawmakers and regulators while balancing such goal

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47 Id.
against its ultimate objective of protecting U.S. investors. When faced with mounting public pressure to recent corporate scandals, Congress enacted SOX which “mark[ed] a radical change in the attitude of the United States to the application of its corporate governance rules to foreign issuers.”

Sarbanes-Oxley Act

In July 2002, Congress passed SOX, a compilation of laws, intended to strengthen corporate governance and protect shareholders and employees by prescribing, among other things, new audit rules, new disclosure requirements and a prohibition on loans to executives. The prohibition on loans to executives was added to SOX just prior to its enactment. The legislative history of SOX, shows that the House of Representative bill approved in April 2002, included a provision requiring disclosure of loans involving executives to be reported immediately after such transaction. The bill also required subsequent SEC regulations imposing additional disclosure requirements in periodic reports and registration statements, filed with the SEC and available to the public, relating to loans to officers and directors on terms not available to the public. On July 25, 2002, Senator Schumer stated that the Senate was “[i]ntroducing... amendments...[to SOX] to further limit the ability of company execs from personally manipulating and rigging the system for their personal benefit and interest.” Prior to the enactment of SOX, there was concern relating to the impact of SOX on foreign issuers. Senator Enzi acknowledged the “need to be clear with respect to the area of foreign issuers and their coverage under the bill’s broad definitions[]” [He noted] the SEC historically has permitted the home country of the issuer to implement corporate governance standards...[and noted] [foreign issuers are not part of the current problems being seen in the U.S. capital markets.]


51 Transactions involving officers or directors of an issuer must file a report on loans to officers, directors or affiliated persons if such loans are made on terms not available to the public. Such reports must be filed with the SEC and made available to the public by the end of the next business day following the loan transaction. HR 3763, 107th § 4(b) (2002), 2002 WL 32054444.

52 HR 3763, 107th § 6 (2002), 2002 WL 32054444.

53 148 CONG REC S 7350, 7361 (daily ed. July 25, 2002), LEXEE 148 Cong. Rec. S. 7350 (statement of Sen. Schumer). Senator Feinstein supported Senator Schumer and co-sponsored §402. She stated that “these loans can create conflicts of interest that limit the ability of outside directors, in particular, to voice their criticism of the institution... I see no justification for providing loans to corporate directors or executive officers. The goal of the reforms that we are currently debating should be to create an environment in which outside directors and major corporate officers act in as pure and honest a manner as possible.” 148 Cong. Rec. S6734-6793 (daily ed. July 15, 2002) (statement of Sen. Feinstein), 2002 WL 32054486.

54 148 CONG REC S 7350, 7356 (daily ed. July 25, 2002), LEXEE 148 Cong. Rec. S. 7350. (statement of Sen. Enzi). But there were instances of excessive loans made by foreign corporations. In Ireland, the Office of the Director of Corporate Enforcement reported five cases in 2003 of loans in excess of $1.2 million, which in some instances, were in excess of corporate assets. Caseload of Irish Company Watchdog Soars. AGENCE FRANCE-PRESSE, May 31, 2004 available at 2004 WL 81248161.

55 § 402 as adopted can be found, in pertinent part, in Appendix A below.
(1) It shall be unlawful for any issuer...to extend or maintain credit...or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.\textsuperscript{56}

(2) Paragraph (1) does not preclude any home improvement and...home loans, consumer credit,...or a charge card,...or any extension of credit by a broker or dealer...to an employee...to buy, trade, or carry securities,...that is—\textsuperscript{57}

(A) made or provided in the ordinary course of...business;
(B) a type...generally made available by such issuer to the public; and
(C) made by such issuer on market terms, or terms no more favorable than those offered by the issuer to the general public for such extension of credit.\textsuperscript{58}

(3) Paragraph (1) does not apply to any loan made or maintained by an insured depository institution (as defined in §3 of the Federal Deposit Insurance Act (12 USC 1813))\textsuperscript{59} if the loan is subject to the insider lending restrictions of §22h of the Federal Reserve Act (12 USC 375b).\textsuperscript{60}

Penalties for violating §402 include (i) sanctions under the Securities Exchange Act of 1934, (ii) SEC injunctions, penalties up to $500,000 and cease and desist orders, (iii) imprisonment for up to 20 years (iv) fines up to $25 million for corporations and $5

\textsuperscript{57} Id.
\textsuperscript{58} Id.
\textsuperscript{59} "The term "insured depository institution" means any bank or savings association the deposits of which are insured by the Corporation pursuant to this Act (12 USCS §§ 1811 et seq.)12 USCS § 1813 (c)(2)(2004).
\textsuperscript{60} PUB. L. NO. 107-204 §402 (2004). The insider lending restrictions of §22 h of the Federal Reserve Act state that (i) loans to executives, directors or principal shareholders on preferential terms are prohibited, (ii) such loans must be made on the same terms offered to non-executives on current prevailing terms, (iii) such loans must carry a normal risk of default, (iv) such loans must be subject to underwriting procedures comparable to non-directors and executives, (v) loans on preferential terms may be extended to executives and directors as part of compensation or benefit program offered to all employees as long as executives and directors are not given preference over other employees, (vi) such loans must be approved by the bank's board of directors, with any interested person abstaining from approval. (vii) loan(s) to an individual executive or director cannot exceed a specified amount as aggregated pursuant to 12 USCS §84. (viii) aggregated loans to all executives and directors cannot exceed the banks unimpaired capital and unimpaired surplus (subject to exceptions by the Federal Reserve Board), and (ix) executives, directors and principal shareholders of affiliates and subsidiaries are treated as such with respect to the bank. 12 USCS 375B (2004). The Federal Reserve Board "may prescribe such regulations...as it deems to be necessary to effectuate the purposes and prevent evasions of this section." 12 U.S.C. § 375B(10)(2004). Directors or officers who knowingly violate 12 U.S.C. § 375b or regulations thereunder, may be subject to personal liability for damages to the bank, its shareholders, or any other person sustaining damages because of such violation. 12 U.S.C. § 503 (2004).
million for individuals. Violators also "may be subject to State law derivative actions to recover proceeds of the loans and aiding and abetting claims may also be possible." After the enactment of §402, interest groups began applying pressure on the SEC to provide further exemptions to the prohibition on loans. Congress, in opposition to amending § 402, recorded their resistance to further exemptions in the congressional records. In February 2003, Senator Levin stated that "This measure alone, is stopping companies from giving billions of dollars in insider loans to corporate executives...[and] should help restore investor confidence." He further noted that "[o]pponents of this reform are continuing to seek ways around it, but I hope my colleagues will join me in understanding the importance of this reform and the need to ensure it reaches its full potential." Furthermore, members of the Senate conveyed their concern to Harley Pitt, Chairman of the SEC, in a letter dated September 25, 2002 that urged him to resist efforts to weaken the prohibition under §402.

Concerns relating to §402 of SOX mounted due to the perceived "substantial ambiguities and "lack of official guidance." Twenty-four law firms responded to concerns by circulating a "consensus view" memorandum that provided guidance on the provisions of §402. In particular, §402 was criticized for "reducing flexibility needed by boards in structuring executive compensation and...eliminating alternatives which would better serve shareholder interests." Critics of § 402 argued that the provision was "[h]astily enacted...[and] the result of a swift political reaction to...recent corporate scandals. Many of the Act's ambiguities and contradictions would have been avoided and the purposes and effectiveness of the Act would have been better served had the time been taken to think through many of the complex issues covered by this important piece of reformist legislation."}

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62 Cleary, Gottlieb, Steen & Hamilton Memorandum, supra note 61, at 686.
64 Id.
65 Id.
66 Letter from Susan M. Collins and Carl Levin, Senate Committee of Governmental Affairs, to Harvey L. Pitt, Commissioner, SEC (Sept. 25, 2002) reprinted in 149 CONG. REC. 2179-2180 (2002). The letter stated "media reports indicate that some companies may be pressing the SEC to narrow the scope of the prohibition or otherwise weaken it through regulation and guidance. or other means...the statutory prohibition makes it clear that publicly traded companies are not supposed to be using company funds to provide personal financing to company directors or officers for any reason: financing is instead to be provided by lenders, credit card operators or other third parties engaged in the ordinary course of business." Id at 2180.
68 Id. "By creating the blueprint, the [law firms] have become the "de facto" regulator when it comes to Section 402...There also remains the issue of the consequences to companies that heed the advice set forth in the blueprint if the SEC ultimately disagrees with one or more of the positions espoused by these law firms." Id.
69 Siske, supra note 61, at 1365.
70 Gerakis and Moawad, supra note 67, at 14.
In addition to the concerns acknowledged domestically, there was also dissatisfaction abroad. The Union of Industrial and Employers' Confederation of Europe ("UNICE") stated that SOX imposed U.S. corporate governance practices on foreign issuers and such imposition was a substantial departure from the former U.S. policy of generally exempting foreign issuers from such rules and regulations in recognition of the fact that corporate governance was a reflection of its home countries "laws, regulations, [self-regulatory bodies,] accepted practices and...legal and economic culture." 71 UNICE noted in particular, the "discriminatory treatments and extraterritorial effects" of §402. 72 The European Union ("EU") also expressed consternation over the "unnecessary outreach effects" on companies from EU member states and identified §402 as one of EU's "7 main areas of concern." 73 Mr. Bolkstein, Commissioner of the EU, wrote:

"While the U.S. authorities rightfully expects the same standards of conduct from companies raising capital on American markets irrespective of whether they are domiciled in the United States or overseas, they are not necessarily better placed than other relevant authorities to establish precise rules that ought to apply outside the U.S. jurisdiction. Unless exemption is granted, many EU companies and audit firms will be subject to super equivalent rules, leading at best to duplication and at worst to conflict of rules, confusion, double jeopardy and certainly unnecessary costs." 74

Lending Restriction Imposed on Domestic Banks in the United States

In response to the U.S. banking crisis of the 1930s, Congress enacted rules and regulations relating to loans to bank insiders which they perceived as a threat to the


73 Communication from the Commission to the Council and the European Parliament-Reinforcing the Statutory Audit in the EU. COM (2003) 286 at §3.11.

74 Written Question by Erik Meijer to the Commission. Application of the most effective methods of combating corporate fraud to companies operating or listed insider and outside the EU. CELEX Response Letter by Mr. Bolkstein on behalf of the Commission dated August 14, 2003. 2003 WL 59440378. EU also noted that "[a] transatlantic (and global) capital market cannot be achieved unless the EU and the U.S. mutually recognise the equivalence of high quality regulatory systems." Communication from the Commission to the Council and the European Parliament-Reinforcing the Statutory Audit in the EU. COM (2003) 286 at §3.11.
banking system.\textsuperscript{75} Currently, Regulation O, which is comprised of several provisions, provides lending restrictions relating to officers and directors of U.S. banks.\textsuperscript{76}

Regulation O provides that loans to insiders\textsuperscript{77} of the bank or insiders of its affiliates\textsuperscript{78} must be "made on substantially the same terms (including interest rates and collateral) as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank" offered to the public and other employees.\textsuperscript{79} Such loan must "not involve more than the normal risk of repayment or present other unfavorable features."\textsuperscript{80} Regulation O provides that such loans are not subject to the restrictions relating to similar terms, underwriting procedures and risk of repayment (specified above) if the loan is made pursuant to a compensation program that is offered to all employees of the bank and such program does not give preferential treatment to officers and directors of the bank.\textsuperscript{81} Furthermore pursuant to Regulation O, subject to certain exceptions, lending to insiders of the bank or insiders of its affiliates, as aggregated, cannot exceed the bank's unimpaired capital and surplus.\textsuperscript{82} Loans to individual insiders of the bank or insiders of its affiliates cannot exceed the greater of (i) $25,000 or (ii) 5\% of unimpaired capital and surplus of the bank unless approved by the board of directors of the bank.\textsuperscript{83} Regulation O also provides that loans to executive officers of the bank may only be extended (i) "to finance the education of the executive officer's children;" (ii) "finance or refinance the purchase, construction, maintenance, or improvement of a residence of the executive officer;" (iii) if such loans are secured by certain instruments enumerated in 12 C.F.R. 215.4(d)(3); or (iv) loans for any purpose other than those listed in (i) and (ii) above not exceeding the greater of (i) $25,000 or (ii) 2.5\% of unimpaired capital and surplus of the bank.\textsuperscript{84} Finally, pursuant to Regulation O, all loans to executive officers must be reported to the bank's board of directors.\textsuperscript{85} As part of its reporting requirements, banks must disclose the total amount of loans furnished to insiders, the number of insiders given loans exceeding the lesser of 5\% of the bank's unimpaired capital and surplus or $500,000, as well as information on loans to executive officers, including the number of such loans outstanding, the interest rate on such loans and the dollar amount of such loans.\textsuperscript{86} Penalties for violating restrictions

\textsuperscript{75} Lemieux, supra note 39, at 172. The laws were later extended and/or amended in response to bank failures in the late 1970's and late 1980's. Id.
\textsuperscript{76} 12 C.F.R 215 (2004).
\textsuperscript{77} Insider is defined as "an executive officer, director, or principal shareholder, and includes any related interest of such a person." 12 C.F.R. 215.2(h) (2004).
\textsuperscript{78} Affiliate is defined as "any company of which a member bank is a subsidiary or any other subsidiary of that company." 12 C.F.R. 215.2(a) (2004).
\textsuperscript{81} 12 C.F.R 215.4(a)(2) (2004).
\textsuperscript{82} 12 C.F.R 215.4(d)(1) (2004). Banks with less than $100 million in deposits are given an exception to this rule. Such banks may loan up to two times its unimpaired cash and unimpaired surplus if the bank "meets or exceeds...all applicable capital requirements established by the appropriate federal banking agency" and the board of such bank adopts a resolution certifying the need for such a limit. 12 C.F.R. 215.4(d)(2) (2004).
\textsuperscript{83} 12 C.F.R. 215.4(b) (2004).
\textsuperscript{84} 12 C.F.R. 215.5(b) (2004).
\textsuperscript{85} 12 C.F.R. 215.5(d) (2004).
\textsuperscript{86} Id. Banks must furnish the names of executive officers for which loans in excess of $25,000 were reported in the quarterly report upon written request. Lemieux, supra note 39, at 175.
under Regulation O include penalties of up to $5,000 for each day the violation continues, penalties of up to $25,000 per day if regulators find a pattern of conduct and a loss to the bank or a gain to the insider resulting from the loan, and penalties of up to the lesser of $1 million or 1% of the bank’s assets per day for knowing violations which cause substantial loss to the bank or substantial gain to the insider resulting from such loan.87

Regulation of Foreign Banks in the United States

U.S. branches and agencies of foreign banking institutions operating in the U.S are regulated by the Federal Reserve.88 Pursuant to the Foreign Bank Supervision Enhancement Act of 1991, branches and agencies of foreign banking institutions are prohibited from accepting insured deposits.89 In order for a foreign bank to accept such deposits, the bank must establish a U.S. subsidiary that would be qualified as an insured depository institution and subject to all U.S. banking laws and regulations.90 Currently, only 10 of the 46 foreign banks listed in the U.S. markets have established a FDIC-insured U.S. subsidiary.91 “Foreign banks [maintain] that the inability of foreign banks to qualify for the “insured depository” exemption [under § 402] places them at a disadvantage compared to their U.S. counterparts92 in that such foreign banks were wholly precluded under § 402 from offering officers and directors loans while their U.S. counterparts, with whom they compete in the U.S. market, were not so prohibited.93 “In addition, and more generally, Section 402 is an unprecedented intrusion into the corporate practices and governance of foreign private issuers, a step that the Commission and the U.S. securities exchanges have deliberately avoided taking in the past.”94

87 Id.
88 GAO Report, Foreign Banks Internal Controls and Audit Weaknesses in U.S. Branches, 3
GAO/GGD 97-181. “Branches are legal and operational extension of foreign banks, and they have
broad banking powers, including accepting uninsured deposits, lending, money market services,
trade financing, and other activities related to the service of foreign and U.S. clients. Agencies have
similar powers but may not accept deposits from U.S. citizens or residents.” Id. at 2.
89 Id. at 3.
94 Letter from Edward F. Greene, Cleary, Gottlieb, Steen & Hamilton, to Martin Dunn, Deputy Director, and Paul M. Dudek, Chief. SEC. 2 (August 16, 2002) available at
http://www.jibl.org/letters&speeches/.
Amendment to §402 of SOX Exempting Foreign Banks from the Prohibition on Loans to Directors

Pursuant to §3 of SOX, the SEC was given the authority to impose "rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of [the] Act." In September 2003, the SEC sought to remedy the perceived inequitable treatment of foreign banks as compared to domestic banks under §402 by proposing an amendment to §402 extending an exemption to foreign banks subject to certain conditions. The SEC published proposed Rule 13k-1 in September 2003, and a subsequent final rule adopted in April 2004, relating to such exemption, which provided certain conditions under which a foreign bank would be eligible for an exemption to §402. The SEC determined that extending such exemption would not disrupt the spirit of SOX because they found no evidence in the legislative history of the Act to conclude that Congress sought to treat foreign banks in a disparate way. After the release of the proposed rule, the SEC received twenty comment letters relating to such rule. An analysis of the proposed rule, substantive comments received to the proposed rule and the final Rule 13k-1 adopted follows.

Definitions and Scope of the Rule

Under the proposed rule, a foreign bank listed in the U.S. or its parent company could be eligible for the exemption to §402 subject to the enumerated conditions. A foreign bank was defined as "an institution that is incorporated or organized under the laws of a country other than the United States...regulated as a bank in such country ...and engaged substantially in the business of banking." The business of banking was defined as "receiving deposits to a substantial extent in the regular course of its business.

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97 The text of the proposed rule and final rule adopted can be found in Appendix B below. "When crafting this proposed foreign bank exemption, we have attempted to strike the appropriate balance among various approaches. Subjecting foreign banks to all of the Federal Reserve System's detailed requirements in this area does not seem necessary or appropriate, especially when many foreign banking regulators have well developed regulatory schemes related to insider lending". Id.
98 Id. To the contrary, the legislative history shows Senator Enzi acknowledged that "[f]oreign issuers are not part of the current problem being seen in the U.S. capital markets and I do not believe it was the intent of the conferences to export U.S. standards disregarding the sovereignty of other countries as well as their regulators." 148 CONG REC S 7350. 7356 (daily ed. July 25, 2002). LEXSEE 148 Cong. Rec. S 7350. (statement of Sen. Enzi)
101 Id.
having the power to accept demand deposits, and extending commercial or other types of credit. A parent company was defined as a "corporation or other organization that directly or indirectly owns more than 50 percent of the voting securities or the equity of the foreign bank." Commentators criticized the scope of the proposed rule because it did not extend the exemption to loans to officers and directors of a subsidiary or affiliate of a foreign bank. Commentators also urged the Commission to revise the definition of parent company in order to make it comparable to such terms as used under U.S. banking law which defines a parent company as holding 25% of the voting securities of the bank. Finally, critics maintained that defining a foreign bank narrowly, as one which has the power to accept demand deposits and extend credit, was unnecessary and that the SEC should only require that a foreign bank is regulated as such in its home jurisdiction to qualify as a foreign bank under the rule.

The definitions of "bank," "affiliate," "subsidiary," and "parent" vary worldwide. For instance, in Argentina, a "financial institution" is defined as an entity which "regularly engages in financial intermediation activities, regardless of whether the entity is publicly or privately owned, or engages in a broader range of business activities beyond financial intermediation." A bank affiliate is defined as "any enterprise or

102 Id.
103 Id.
104 Letter from Sullivan & Cromwell LLP, to Jonathan Katz, Secretary, Securities and Exchange Commission, 6 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. ("We do not believe that excluding sister companies or subsidiaries from the Proposed Rule is consistent with the Commission's goal of parity.") Letter from R. Kelly Shaughnessy, Vice President of Banking Operations, Canadian Banking Association, to Jonathan Katz, Secretary, Securities and Exchange Commission, 3 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. ("We recommend that the exemption be extended to cover bank subsidiaries.") and Letter from C.A. Margelisch and A. Hubschmid, Swiss Bankers Association, to Jonathan Katz, Secretary, Securities and Exchange Commission, 6 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. ("Loans by a foreign bank to the directors and executive officers of a non-bank issuer that is an affiliate or subsidiary of the foreign bank would not be permitted by the proposed regulation. In contrast, similar loans to insiders of an affiliate of a domestic bank are permitted.") Letter from Lawrence R. Uhlick, Institute of International Bankers, to Securities and Exchange Commission, 5 (October 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. ("It would be consistent with the Commission's rationale...to make indirect loans through affiliates eligible for the exemption as well.")
105 Letter from Lawrence R. Uhlick, Institute of International Bankers, to Securities and Exchange Commission, 5 (October 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. ("Revising the definition of "parent company" in this way will ensure that a loan to an insider of a holding company issuer that owns 30% of the foreign bank that makes the loan would be eligible for the exemption under Rule 13k-1. just as a comparable loan by a U.S. bank would be exempt under the statutory exemption in Section 13(k).") Letter from Shearman & Sterling LLP to Jonathan Katz, Secretary, Securities and Exchange Commission, 5 (Oct. 15, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. ("It appears sound to adopt the [The Bank Holding Act of 1956] approach of ownership of 25% of the voting securities...Regulation O is based on that ownership percentage...and it is difficult to justify a less favorable treatment of foreign bank holding companies.")
106 Id. at 4.
107 2 Regulation of Foreign Banks: United States and International, at 6 (Michael Gruson & Ralph Reisner eds. 2000). "Financial intermediation is defined as an "entity [which] borrows or otherwise
person directly or indirectly exercising control over the bank; any enterprise or person directly or indirectly controlled by the same persons exercising control over the bank; any corporation that shares directors with the corporation that controls the bank; or the bank itself when the common directors constitute a majority of both boards of directors, and any enterprise or person having a relationship with a bank or entity that controls the bank...that could cause economic harm to the bank.”

Under Italian law, a bank is defined as “an enterprise authorized to conduct banking activities.” A bank affiliate is defined as “any bank, nonbank financial institution, or instrumental company controlled by a bank or nonbank financial holding company.”

Under French law, a bank is defined as “any corporation usually and professionally engaged in banking operations.”

The final rule was edited to incorporate several of the comments. First, the definition of foreign bank was amended to reflect a definition comparable to the same term used in the Federal Reserve Board’s Regulation K which is “an institution, the home jurisdiction of which is other than the United States, that is regulated as a bank in its home jurisdiction, and that engages directly in the business of banking.” The definition of the “business of banking” was also amended to include “banking activities that are usual for the business of banking in its home jurisdiction.” The final rule also expanded the scope of the exemption to include affiliates and subsidiaries in addition to a parent company of a foreign bank. The rule defined “affiliate” as “a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.”

The final rule also adopted the same definitions of “parent” and “subsidiary” as defined under 17 CFR 240.12b-2 which was “an affiliate controlling such person directly, or indirectly controlling through one or more intermediaries” and “an affiliate controlled by such person directly, or indirectly through one or more intermediaries”, respectively. The expanded scope of the

acquires money or financial resources from another entity, and then lends the money or financial resources so acquired to another, or invests the same with a third party.”

106 Id at 18.
107 Id at 534. Banking activities include deposit taking and credit lending. Banks are also permitted to conduct other types of financial activities beyond deposit taking and credit lending. Id at 534-535.
108 Id at 554.
109 Id at 294. Banking operations consist of “receiving funds from the public, credit operations and providing and managing payment means.”
111 Id. The SEC agreed that the term should be generally defined to ensure that all types of foreign banks would be eligible for the exemption. Id. “[I]t is reasonable to adopt a foreign bank definition that is substantially similar to the definition upon which foreign banks have relied when seeking regulatory approval for their U.S.-based banking activities.”
112 Id. The SEC stated “we agree with these commenters that expansion of the foreign bank’s exemption’s scope is necessary to accommodate the insider lending practices of foreign banks organized in jurisdictions that permit loans to insiders of the foreign bank’s affiliates.”
113 Id. Definition is identical to term used under 17 CFR 240.12b-2 (2004).
114 Id. and 17 C.F.R. § 240.12b-2 (2004). The SEC did not adopt a definition of “parent that would have required a company to own or control a majority of a company’s voting shares. [The SEC instructed] issuers [to] consult precedent under the federal securities laws when determining whether a particular entity can be a parent company if it directly or indirectly owns or controls less than 50 percent of a company’s voting shares.”

Foreign Bank Exemption From The Insider Lending.
exemption achieves equality with rules pertaining to domestic banks and loans to affiliates under Regulation O. Finally, the SEC clarified that the rule did not apply to foreign governments registered as an issuer on Schedule B of the Securities Act because § 402 is not problematic for foreign governments which do not generally have directors and executive officers.

**Condition One of the Exemption**

The first condition of the proposed rule required that either a foreign bank insure its deposits pursuant to its home jurisdiction’s laws and regulations or, alternatively, that the Federal Reserve Board (the “Board”) previously determined that the foreign bank is subject to comprehensive supervision or regulation by its home country supervisor. (“CCS determination”) The first alternative of the condition is not problematic for many foreign banks because many nations have adopted a deposit insurance scheme. Currently, “34 European countries, 10 African countries, 8 Asian countries, 4 Middle Eastern countries and 16 Countries from North and South America” have implemented a form of deposit insurance. With respect to the first alternative, one commenter suggested that the term be more broadly defined to include “deposit protection or guarantee schemes” because deposit insurance was “a term of art of U.S. bank regulation.” Another commenter urged the SEC not to impose any further requirements relating to deposit insurance stating that “deference to the foreign banking supervisor regarding details of its deposit insurance scheme is appropriate, and...no minimum quantitative or qualitative criteria for the deposit insurance scheme should be specified.”

As noted above, many countries have some form of deposit insurance but the form and substance of such insurance vary. For instance, in Italy there are two private deposit guarantee schemes available to Italian bank depositors which protect deposits up to 100,000 euro. Bank membership in such schemes is required. Furthermore, depositors are protected in the event of bank insolvency by statutes which provide further...
safeguards. In England, the Governor of the Bank of England oversees the Deposit Protection Board. The "Deposit Protection Fund is privately funded through levies on authorized banks with no direct financial backing from the Bank or U.K. taxpayers." In France, the Association Francaise des Banques has implemented a deposit insurance program in which all deposits up to 400,000 francs are insured, with an annual cap of 200 million francs on such program. In 1996, the Fonds de Garantie des Depots was created which indemnified deposits not protected by the deposit insurance program. In Canada, the Canada Deposit Insurance Corporation insures deposits up to 60,000 per person and Canadian banks are required to participate. In Germany, under the German Deposit Guarantee Act of 1998, 90% of the aggregated value of deposits must be insured but may be limited to an aggregated maximum of 20,000 euro per depositor. Finally, in Australia, there is no deposit insurance protection, but, in the event of a bank default, the banking regulatory authority has the power to appoint a manager to such bank in order to ensure the bank’s ability to meet its deposits and Australian law provides that deposit liabilities take priority over other debts of a defaulting bank.

The second alternative, a favorable CCS determination, requires the Board to find that the foreign bank’s home country supervisor: (i) ensures that the bank’s worldwide activity is properly monitored and controlled; (ii) requires disclosure of audit reports on the bank’s worldwide financial condition and transactions between the bank and its affiliates; and (iii) evaluates capital adequacy and risk assessment standards. The SEC received many proposals with respect to the second alternative relating to CCS determinations. Commentators proposed that the second alternative be revised to allow foreign banks to rely on a favorable CCS determination given to another bank from its home country. One commentator stated, “[i]n the Institute’s view, denying an international bank from a CCS jurisdiction the benefit of the exemption solely because it had not had occasion to file a relevant application with the Federal Reserve

125 Id at 559.
126 GAO Report, Bank Regulatory Structure-The United Kingdom, 4 GAO/GGD 95-38.
127 Id.
128 Id. at 155-156.
129 Id. at 406-407.
130 Id. at 72-73.
131 Foreign Bank Exemption from the Insider Lending prohibition of Exchange Act Section 13(k), Exchange Act Release No. 34-48481, International Series Release No. 1272, File No. s7-15-03 (September 11, 2003). In certain cases, the Board may provide a favorable determination if the home country supervisor is working towards the above mentioned standards and there are other factors that are consistent with a favorable determination. Id.
132 Letter from C.A. Margelisch and A. Hubschmid, Swiss Bankers Association, to Jonathan Katz, Secretary, Securities and Exchange Commission. 3 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/671503.shtml. (The “SBA also recommends that this exception be extended to all banks from a country once one bank from that country achieves the CCS designation because no sound policy objective would be served by requiring future bank issuers from home jurisdictions that have been found to subject similarly regulated banks to CCS to achieve their own specific CCS designation.”)
Board...would be an unreasonable result."\textsuperscript{135} The European Banking Federation requested a blanket exemption to §402 for European banks arguing that:

"EU member states use an array of equally effective methods and means, to avoid a conflict of interest in the process of granting loans to executives of the lender. Thus, to safeguard national treatment and to prevent conflicts of legislation, the FBE has invited the SEC to provide a blanket exemption for European banks because of the functional equivalence of their home country rules with Regulation O, applying to U.S. banks."\textsuperscript{136}

The Canadian Imperial Bank of Commerce suggested that the SEC amend the rule to provide that any foreign bank with a favorable CCS determination automatically qualify for an exemption to §402, notwithstanding the other enumerated conditions.\textsuperscript{137}

The final rule clarified that deposit insurance included deposit protection and guarantee schemes and allowed foreign banks to rely on a favorable CCS determination obtained by a bank from its home country as long as both banks were monitored under substantially similar regulation and supervision.\textsuperscript{138} The SEC stated that "[t]his revision is...consistent with Section 402 since it would render eligible for the foreign bank exemption only banks whose home jurisdiction laws and supervision already have been deemed by the Board to be sufficiently comprehensive to justify permitting another foreign bank to conduct business in the United States."\textsuperscript{139}

**Condition Two of the Exemption**

Pursuant to the proposed rule, the second condition of the exemption required that the foreign bank’s home country laws and regulations limit loans to executive officers and directors unless such bank makes the loans: (i) on terms that are consistent with current market terms or; (ii) pursuant to a benefit program available to all bank employees, and executive officers and directors do not enjoy preferential terms over other employees; or (iii) following the approval of the loan by the foreign bank’s home country supervisor.\textsuperscript{140}


\textsuperscript{136} Letter from Nikolaus Bomcke, European Banking Federation, to Jonathan Katz, Secretary, Securities and Exchange Commission, 1-2 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. ("The FBE...endorsed the proposal...stipulating that banks from countries which...provide comprehensive consolidated supervision...over their banking institutions...should be exempt from the lending prohibitions of Section 402.")


\textsuperscript{138} Foreign Bank Exemption From The Insider Lending Prohibition of Exchange Act Section 13(k). Release No. 34-49616, International Series Release No. 1275., File No. s7-15-03 (April 26, 2004). The SEC expects a “good faith assessment” that the foreign bank’s regulation is substantially similar to the regulation of the bank with the favorable CCS determination. Id.

\textsuperscript{139} Id.

Commentators criticized the second condition because many foreign banks would be unable to qualify for the exemption due to laws and regulations in their home country which do not regulate loans to insiders as prescribed by the rule and over which such companies had no control.\textsuperscript{141} Furthermore, "[i]n many jurisdictions...recognized and enforceable requirements that apply to banking operations are not necessarily specified in formal regulations...acceptable banking practices have evolved...and are understood as part of recognized custom and practice."\textsuperscript{142} Commentators noted that requiring that a foreign bank's home country impose specific insider lending restrictions does not add substantive value over requiring foreign banks to adhere to the enumerated restrictions in fact.\textsuperscript{143} One commentator argued that the condition was "inconsistent with the deference that is customarily accorded to regulators in jurisdictions that adhere to recognized international standards of banking supervision," such as the Basel Committee on Banking Supervision of the Bank for International Settlements Principle 10 ("Principle 10").\textsuperscript{144} Finally, One commenter warned - "[t]o add a requirement that foreign insider lending restrictions must be substantially similar to Regulation O...seems

\textsuperscript{141} Letter from Sullivan & Cromwell LLP, to Jonathan Katz. Secretary, Securities and Exchange Commission. 2 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. See Letter from Deutsche Bank Aktiengesellschaft, to Jonathan Katz. Secretary, Securities and Exchange Commission. 2 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. ([It should not be relevant whether home jurisdiction insider lending laws would permit a broader range of insider loans...as drafted, the Condition could lead to circumstances in which even minor deviations of the text of foreign law...could be interpreted as leading to inapplicability of the exemption.]


\textsuperscript{144} Letter from C.A. Margelisch and A. Hubschmid, Swiss Bakers Association, to Jonathan Katz. Secretary, Securities and Exchange Commission. 2 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. Principle 10 states, in pertinent part, "banking supervisors must have in place requirements that banks lend to related companies and individuals in an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks." The criteria for extending such loans pursuant to Principle 10, include: [(i)] "[t]he supervisor has discretion, which may be prescribed in law, to make judgments about the existence of connections between the bank and other parties; [(ii)] laws and regulations exist that exposures to connected or related parties may not be extended on more favourable terms...than corresponding loans to non-related parties (an exception may be appropriate for beneficial terms that a part of overall remuneration packages...); [(iii)] the supervisor requires [such] transactions...exceeding specified amounts or otherwise posing special risks are subject to approval by the bank's board of directors; [(iv)] the supervisor requires that banks have procedures...to prevent persons benefiting from the loan being part of the preparation of the loan assessment or of the decision itself; [(v)] laws or regulations set, or the supervisor has the mandate to set on a general or case-by-case basis, limits for loans to connected and related parties, to deduct such lending from capital when assessing capital adequacy or to require collateralization of such loans; [(vi)] the supervisor requires banks to have information systems to identify individual loans to connected and related parties as well as the total amount of such loans, and to monitor them through an independent credit administration process; [(vii)] the supervisor obtains and reviews information on aggregate lending to connected and related parties." Basel Committee on Banking Supervision, Core Principles Methodology. 25 (October 1999).
to be an unnecessary and psychologically unwise imposition of U.S. regulations on foreign countries.145

The proposed second condition was problematic for banks domiciled in many foreign countries. For instance, ICICI Bank, domiciled in India, would be unable to qualify without a change to Indian law which only restricted loans to directors.146 The condition would also be problematic in Australia, where loans to related parties, which does not include executive officers who are not restricted under law, are permitted in arms length transactions or when such loans are approved by shareholders.147 Canadian law permits loans on preferential terms to senior officers if such loan is approved by the bank's conduct review committee of the board of directors.148 German law requires approval of the bank’s management and supervisory boards for loans to members of the boards or their family members.149 In Switzerland, restrictions on insider loans may not be specified in formal law but such restriction have evolved into accepted practices.150 “Italian law, which once prohibited directors, general managers, and members of the board of auditors of a company from obtaining loans from the company or its subsidiaries, has recently been amended, to allow an Italian company to grant such loans.”151

Commentators made many suggestions on how to cure the problems related to the second condition. One recommendation was to provide an exemption to the condition for loans less than $200,000.152 Another suggestion was to amend the rule to provide that a foreign bank would qualify for the exemption if its home country had adequate restrictions on insider lending.153 Another commentator recommended that foreign banks from jurisdictions with a favorable CCS determinations be exempt from the second

146 Letter from Margaret E. Tahyar, Davis, Polk and Wardwell on behalf of ICICI Bank (Indian banking corp.), to Jonathan Katz, Secretary, Securities and Exchange Commission, 3 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. Ms. Tahyar noted that “[w]e do not believe that ICICI Bank’s range of executive compensation or the scope of the standard Indian employee preferential loan program justifies the competitive disadvantage, and large administrative compliance burden imposed upon ICICI Bank and similarly placed non-U.S. banks by the operation of Section 13(k).” Id. at 4.
148 Id.
149 Id.
condition. Another suggestion was to permit loans that comply in fact with one of the three enumerated lending restrictions without regard to whether the foreign bank’s home jurisdiction laws or regulations imposed such condition. The final rule was amended to require that the foreign bank loan need only comply in fact with one of the three insider lending restrictions noted above irrespective of whether the foreign bank’s home jurisdiction laws and regulations imposed such restriction. The SEC noted that certain commentators requested the elimination of the second condition for foreign bank’s whose home country had a favorable CCS determination, but the SEC opted not to make such change because the Federal Reserve Board did not examine insider lending restrictions when issuing CCS determinations.

**Condition Three of the Exemption**

Under the proposed rule, loans to insiders exceeding $500,000 would require the approval of the bank’s board of directors. Many commentators sought to delete this condition stating that it “is not required to achieve the Commission’s purpose and increases the extraterritorial effect of the Proposed Rule” and such condition is “overly burdensome” in that it adds to the duties of the board of directors. The SEC chose to delete the condition stating that “given these concerns, and because the board approval condition does not appear to be necessary to further the rule’s purpose of protecting against improper insider lending, we have eliminated the proposed third condition in its entirety.”

**Amended Form 20-F**

The SEC also proposed an amendment to Form 20-F, a statement filed annually by all foreign issuers, to require foreign banks to disclose information relating to

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155 Letter from Deutsche Bank Aktiengesellschaft, to Jonathan Katz, Secretary, Securities and Exchange Commission, 2 Oct. 17, 2003 available at http://www.sec.gov/rules/proposed/s71503.shtml. “We believe that, so long as a loan is in fact made pursuant to the core rules of Regulation Q of the Commission has identified, it should not be relevant whether home jurisdiction insider lending laws would permit a broader range of insider loans.” Id.


157 Id.


problematic loans to insiders, including the name of the recipient and details of the transaction. Critics argued that such disclosure was (i) not required under Regulation O, which requires domestic banks to disclose the dollar amount of outstanding loans and the range of interest rates of such loans, and upon written request, the identities of executive officers and principal shareholders with loans in excess of $500,000 and (ii) such amendment would be problematic for many foreign banks whose home countries have adopted privacy laws which would prohibit the dissemination of such information. The final rule did adopt an amended Form 20-F, but acknowledged the potential conflict between the amended Form 20-F and home country laws relating privacy of consumer data by adding an instruction requiring that if the bank’s home jurisdiction has privacy laws which preclude them from identifying the insider receiving the problematic loan, the corporation must attach a legal opinion attesting to that issue and must provide specified disclosure that does not identify the recipient.

General Implications of Exemption as Adopted

The SEC noted certain general costs and benefits associated with the rule. The SEC noted that Rule 13K-1 would “remove…a regulatory impediment that…could discourage foreign banks from entering or remaining in U.S. capital markets.” Furthermore, shareholders of the 46 foreign banks subject to SEC reporting requirements would benefit from the additional reporting requirements in Form 20-F by having information about a foreign bank’s loans to insiders similar to the information that is available to investors with respect to domestic banks, subject to certain exceptions provided to comport with foreign privacy laws as described above. Foreign banks complying with the rule benefit “by being able to, like its domestic counterpart, provide qualified personal loans to its executive officers and directors.” Foreign banks from

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163 Letter from Nikolaus Bomcke, European Banking Federation, to Jonathan Katz, Secretary, Securities and Exchange Commission, 3 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. (“We are of the opinion that such a far-reaching disclosure requirement would neither be mandated by U.S. norms nor provide the accommodation for differing relevant norms in European Countries that is so necessary for the maintenance of strong transatlantic ties.”), Letter from Deutsche Bank Aktiengesellschaft. to Jonathan Katz, Secretary, Securities and Exchange Commission, 2 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. (Regulation O does not require such disclosure relating to domestic banks.) and Letter from C.A. Margelisch and A. Hubschmid, Swiss Bankers Association, to Jonathan Katz, Secretary, Securities and Exchange Commission, 5 (Oct. 17, 2003) available at http://www.sec.gov/rules/proposed/s71503.shtml. (“[This] requirement could effectively prohibit loans to insiders because, should the loan become problematic, the banks would either be put in the position of violating the proposed disclosure requirement or be in violation of home jurisdiction privacy laws.”)
165 Id.
166 Id.
167 Id.
168 Id.
jurisdictions with substantially similar insider lending restrictions to those enumerated under condition two of Rule 13k-1 would further benefit from avoiding duplicative insider lending restrictions. With respect to the costs, the SEC noted that 14 of the 46 banks were subject to substantially similar insider lending restrictions in their home country to those imposed under Rule 13k-1. The remaining 32 banks, subject to lending restrictions less strict than Rule 13k-1, would be subject to an additional cost burden of $237,000 in attorney and professional fees to comply with Rule 13k-1 and an additional burden on staff amounting to 264 working hours in connection with such compliance.

Conclusion

Did the exemption, as adopted, level the playing field for foreign banks and their domestic counterparts? The commentator’s concerns relating to condition one, particularly with respect to the CCS determination, of the exemption were generally resolved. Under the final rule, banks could rely on a favorable CCS determination for another bank from its home country, which alleviated the burden of obtaining such determination itself. The concerns raised regarding condition two were alleviated in the final rule by allowing foreign banks to comply in fact with the insider lending restrictions imposed by the condition instead of requiring each bank’s home jurisdiction to impose the same requirements. This allowed foreign bank’s from countries which did not choose to regulate insider loans as specified in condition two to qualify for the exemption without lobbying for legislative change in its home country. As noted above, satisfying condition two may be costly for foreign banks from home countries in which the insider lending restrictions were less restrictive than Rule 13k-1. Condition two may still be problematic for foreign banks in countries in which it is permissible to offer preferential loans to insiders in order to attract new employees because such banks may be competing with other banks in their home country, who are not listed in the U.S thus not subject to Rule 13k-1, who are able to attract talented employees for management by offering such loans thereby putting U.S. listed banks at an economic disadvantage to their competitors. Finally, the rule as adopted sought to alleviate the potential for a conflict of law with respect to the amended Form 20-F and home country laws relating to privacy by allowing foreign banks, from countries with privacy laws which prohibit them from identifying customers, to provide non-identifying disclosure in the amended Form 20-F although the provision could prove to be costly to foreign banks which must conform to home country privacy laws as well.

In general terms relating to the enactment of SOX, the initial reaction of resentment of foreign corporations has subsided to some extent over time. Since January 2004, there have been 24 initial public offerings of foreign companies on the U.S.

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169 Id.
170 Id.
171 Id. The SEC also noted that with respect to the 32 banks subject to lending restriction less strict than Rule 13k-1, on average each of these banks would make 11 loans to directors and officers of the bank or its affiliates annually. Id.
172 Id.
173 Id.
174 Id.
markets with $5.6 billion raised collectively. Analysts believe exemptions such as Rule 13k-1 which accommodate foreign issuers have helped in attracting foreign corporations to the U.S. But, 2004 has been a record year for class actions suits filed against foreign corporations with 21 cases so far up from 15 in 2003 with most targeting banking or technology firms. Furthermore, many foreign corporations have expressed a desire to deregister with the SEC and delisit from the U.S. markets in light of the additional costs imposed by SOX. John Thain, Chief Executive of the NYSE, stated in connection with the fallout from SOX, “companies ha[ve] told the exchange that the pendulum of regulation had swung too far.” Other companies have reconsidered their need to enter into the U.S. market in light of the Act’s requirements and the associated cost of compliance. Based on the costs imposed by SOX it is likely that the Act will dissuade some foreign companies from continuing in or entering the U.S. capital markets. Such consequences are particularly troublesome in light of the fact that the Act was adopted in connection with scandals involving U.S. corporations, not foreign issuers. As noted by Senator Enzi, “Foreign issuers are not part of the current problems being seen in the U.S. capital markets...it was not the intent...to export U.S. standards disregarding the sovereignty of other countries.”

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176 *Id.*
179 *Id.*
180 *Id.*
APPENDIX A

The text of § 402 of SOX, in pertinent part, is as follows:

(1) IN GENERAL.—It shall be unlawful for any issuer...directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided there is no material modification of any term of any such extension of credit or any renewal of extension of credit on or after that date of enactment.

(2) LIMITATION.—Paragraph (1) does not preclude any home improvement and manufactured home loans,...consumer credit....or any extension of credit under an open end credit plan,...or a charge card....or any extension of credit by a broker or dealer...to an employee of that broker or dealer to buy, trade, or carry securities that is permitted under rules and regulations of the Board of Governors of the Federal Reserve System...that is—

(A) made or provided in the ordinary course of the consumer credit business of such issuer;

(B) of a type that is generally made available by such issuer to the public; and

(C) made by the issuer on market terms or terms no more favorable than those offered by the issuer to the general public for such extension of credit.

(3) RULE OF CONSTRUCTION FOR CERTAIN LOANS.— Paragraph (1) does not apply to any loan made or maintained by an insured depository institution (as defined in §3 of the Federal Deposit Insurance Act (12 USC 1813), if the loan is subject to the insider lending restrictions of §22h of the Federal Reserve Act (12 USC 375b)).

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APPENDIX B

The text of the proposed rule is as follows:

§240.13k-1 Foreign Bank Exemption from the insider lending prohibition under section 13(k).

(a) For the purpose of the section:

(1) Foreign Bank means an institution:

(i) The home jurisdiction of which is other the United States;

(ii) That is regulated as a bank in its home jurisdiction; and

(iii) That is engaged substantially in the business of banking.

(2) Home jurisdiction means the country, political subdivision or other place in which a foreign bank is incorporated or organized.

(3) Engaged substantially in the business of banking means engaged in:

(i) Receiving deposits to a substantial extent in the regular course of business;

(ii) Having the power to accept demand deposits; and

(iii) Extending commercial or other types of credit.

(4) Parent Company of a foreign bank means a corporation or other organization that directly or indirectly owns more than 50 percent of the voting securities or the equity of the foreign bank.

(b) An issuer that is a foreign bank or the parent company of a foreign bank is exempt from the prohibition of extending, maintaining, arranging for, or renewing credit in the form of a personal loan to or for any of its directors or executive officers under section 13(k) of the Act (15 U.S.C. 78m(k)) with respect to any such loan made by the foreign bank as long as:

(1) Either:

(i) The laws or regulations of the foreign bank’s home jurisdiction require the bank to insure its deposits; or

(ii) The Board of Governors of the Federal Reserve System has determined that the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by the bank supervisor in the foreign bank’s home jurisdiction under 12 CFR 211.24(c); and

(2) The laws or regulations of the foreign bank’s home jurisdiction restrict the foreign bank from making loans to its executive officers and directors or those of its parent company unless the foreign bank is permitted to and does extend the loan:

(i) On substantially the same terms as those prevailing at the time for comparable transactions by the foreign bank with other persons who are not executive officers, directors or employees of the foreign bank or its parent company; or

(ii) Pursuant to a benefit or compensation program that is widely available to the employees of the foreign bank or its parent company and does not give preference to any of the executive officers or directors of the foreign bank or its
parent company over any other employees of the foreign
bank or its parent company; or
(iii) Following the express approval of the loan by the bank
supervisor in the foreign bank’s home jurisdiction; and
(3) For any loan that, when aggregated with the amount of all other
outstanding loans to a particular executive officer or director,
exceeds $500,000:
(i) A majority of the foreign bank’s board of directors has
approved the loan in advance; and
(ii) The loan’s intended recipient has abstained from
participating in the vote regarding the loan.
3. Amend Form 20-F (referenced in §249.220f) by revising paragraph
2 of Item 7.B of Part 1 to read as follows: The amount of outstanding
loans (including guarantees of any kind) made by the company or any
of its parent or subsidiaries to or for the benefit of any of the persons
listed above. The information given should include the largest
amount outstanding during the period covered, the amount
outstanding as of the latest practicable date, the nature of the loan and
the transaction in which it was incurred, and the interest rate on the
loan. In addition, if the company, its parent or any of its subsidiaries
is a foreign bank (as defined in 17 CFR 240.13k-1) that has made a
loan to which Instruction 2 of this Item does not apply, identify the
director, executive officer or other related party required to be
described by this Item who received the loan, and describe the nature
of the loan recipient’s relationship to the foreign bank.183

The text of the final rule adopted is as follows:
§240.13k-1 Foreign Bank Exemption from the insider lending
prohibition under section 13(k).

(a) For the purpose of the section:
(1) Foreign Bank means an institution:
(i) The home jurisdiction of which is other than the United States
(ii) That is regulated as a bank in its home jurisdiction; and
(iii) That engages directly in the business of banking.
(2) Home jurisdiction means the country, political subdivision or
other place in which a foreign bank is incorporated or organized.
(3) Engaged directly in the business of banking means that an
institution engages directly in banking activities that are usual
for the business of banking in its home jurisdiction.
(4) Affiliate, parent and subsidiary have the same meaning as under
(b) An issuer that is a foreign bank or the parent or other affiliate of a
foreign bank is exempt from the prohibition of extending.

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maintaining, arranging for, or renewing credit in the form of a personal loan to or for any of its directors or executive officers under section 13(k) of the Act (15 U.S.C. 78m(k)) with respect to any such loan made by the foreign bank as long as:

1. Either:
   (i) The laws or regulations of the foreign bank’s home jurisdiction require the bank to insure its deposits or be subject to a deposit guarantee or protection scheme; or
   (ii) The Board of Governors of the Federal Reserve System has determined that the foreign bank or another bank organized in the foreign bank’s home jurisdiction is subject to comprehensive supervision or regulation on a consolidated basis by the bank supervisor in its home jurisdiction under 12 CFR 211.24(c); and

2. The loan by the foreign bank to any of its directors or executive officers or those of its parent or other affiliate:
   (i) Is on substantially the same terms as those prevailing at the time for comparable transactions by the foreign bank with other persons who are not executive officers, directors or employees of the foreign bank, its parent or other affiliate; or
   (ii) Is pursuant to a benefit or compensation program that is widely available to the employees of the foreign bank, its parent or other affiliate and does not give preference to any of the executive officers or directors of the foreign bank, its parent or other affiliate over any other employees of the foreign bank, its parent or other affiliate; or
   (iii) Has received express approval by the bank supervisor in the foreign bank’s home jurisdiction; and

Notes to paragraph (b):
1. The exemption provided in paragraph (b) of this section applies to a loan by the subsidiary of a foreign bank to a director or executive officer of the foreign bank, its parent or other affiliate as long as the subsidiary is under the supervision or regulation of the bank supervisor in the foreign bank’s home jurisdiction, the subsidiary’s loan meets the requirements of paragraph (b)(2) of this section, and the foreign bank meets the requirements of paragraph (b)(1) of this section.

2. For the purpose of paragraph (b)(1)(ii) of this section, a foreign bank may rely on a determination by the Board of Governors of the Federal Reserve System that another bank in the foreign bank’s home jurisdiction is subject to comprehensive supervision or regulation on a consolidated basis by the bank supervisor under 12 CFR 211.24(c) as long as the foreign bank is under substantially the same banking supervision or regulation as the other bank in their home jurisdiction. (c) As used in paragraph (1) of section 13(k) of the Act (15 U.S.C. 78m(k)(1)), issuer does not include a foreign government, as defined under 17 CFR 230.405, that files a registration statement.
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under the Securities Act of 1933 (15 U.S.C. 77a et seq.) on Schedule B.

3. The authority citation for Part 249 continues to read in part as follows: Authority: 15 U.S.C. 78a et seq. and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

4. Amend Form 20-F (referenced in §249.220f) by revising paragraph 2 of Item 7.B of Part 1, adding new paragraph 3 to Instructions to Item 7.B of Part 1, renumbering paragraph 14 as paragraph 15 of Instructions as to Exhibits, and adding new paragraph 14 of Instructions as to Exhibits to read as follows:

2. The amount of outstanding loans (including guarantees of any kind) made by the company, its parent or any of its subsidiaries to or for the benefit of any of the persons listed above. The information given should include the largest amount outstanding during the period covered, the amount outstanding as of the latest practicable date, the nature of the loan and the transaction in which it was incurred, and the interest rate on the loan. In addition, if the company, its parent or any of its subsidiaries is a foreign bank (as defined in 17 CFR 240.13k-1) that has made a loan to which Instruction 2 of this Item does not apply, identify the director, senior management member, or other related party required to be described by this Item who received the loan, and describe the nature of the loan recipient’s relationship to the foreign bank.

3. In response to Item 7.B.2, if you are unable to identify the recipient of a foreign bank loan to which Instruction 2 of this Item does not apply because you have concluded that such disclosure would conflict with privacy laws, such as customer confidentiality and data protection laws, of your home jurisdiction, you must provide a legal opinion attesting to that conclusion as an exhibit. You must also disclose that:
   (A) an unnamed director, senior management member, or other related party for which disclosure is required by this Item, has been the recipient of a loan to which Instruction 2 of this Item does not apply;
   (B) your home jurisdiction’s privacy laws prevent the disclosure of the name of this loan recipient; and
   (C) this loan recipient is unable to waive or has otherwise not waived application of these privacy laws.

14. The legal opinion required by Instruction 3 of Item 7.B of this Form.184

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