



INTERNATIONAL BANKING FOCUS

A Bimonthly Publication of the
INSTITUTE OF INTERNATIONAL BANKERS

Volume XXIX, Number 4
August 4, 2008

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LEGISLATIVE & REGULATORY

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The Institute's mission is to help resolve the many special legislative, regulatory and tax issues confronting **internationally headquartered** financial institutions that engage in banking, securities and/or insurance activities in the United States.

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INSTITUTE PLANS TO COMMENT ON SEC PROPOSAL TO INCREASE RANGE OF SERVICES BY FOREIGN BROKER-DEALERS

The Institute plans to file a comment letter on the SEC's proposed revisions to Rule 15a-6 that are intended to liberalize existing restrictions on the range of services that foreign broker-dealers can offer to U.S. investors without triggering registration under Section 15 of the Securities Exchange Act of 1934. (The SEC's June 27th press release is available at <http://www.sec.gov/news/press/2008/2008-124.htm>; the Federal Register notice is available at <http://edocket.access.gpo.gov/2008/pdf/E8-15000.pdf>.) Comments on the proposed revisions are due by September 8th. The Institute held a conference call with interested member institutions on July 23 to discuss the planned submission to the SEC.

Among its key provisions, the proposal would expand the types of persons whom an unregistered foreign broker-dealer may contact (including by directly distributing research reports), and with whom it may effect transactions in securities, from the current group of "major U.S. institutional investors" with at least \$100 million in investments to the broader group of "qualified investors" (including natural persons) with at least \$25 million in investments.

In addition, the proposal would eliminate the "chaperoning" requirement of the current rule and significantly diminish the role of a U.S. broker-dealer acting as an intermediary in a transaction between a foreign broker-dealer and a U.S. investor. For example, a foreign broker-dealer would be permitted to effect all aspects of a transaction in foreign securities, including maintaining custody of customer funds and securities, provided that it is regulated with respect to its securities activities –including the specific activities in which it engages with U.S. investors in reliance on this part of the Rule – by a foreign securities authority, generally conducts a "foreign business" (as defined in the Rule) and makes certain disclosures to the investor. The SEC also proposes to codify earlier staff no-action letters dealing with the treatment under Rule 15a-6 of U.S. fiduciaries acting on behalf of offshore clients and the ability of foreign options exchanges to familiarize U.S. investors with their operations.

INSTITUTE PLANS SUBMISSION ON U.S. PROPOSAL TO IMPLEMENT STANDARDIZED APPROACH UNDER BASEL II CAPITAL ACCORD

The federal banking agencies on July 29th published the proposed terms by which they would implement the standardized approach under the Basel II Capital Accord, including the basic indicator approach for operational risk (the Federal Register notice of the proposal is at <http://edocket.access.gpo.gov/2008/pdf/E8-16262.pdf>). The Institute held a conference call on July 30th with interested member institutions to discuss our planned submission on the proposal. Comments are due by October 27th.

The proposal is largely consistent with the standardized approach as adopted by the Basel Committee, but the Basel II standardized approach has been modified in certain significant respects (for example, through the use of loan-to-value ratios to risk weight residential mortgage exposures). In addition, the agencies have requested comment on whether certain features of the advanced approaches should be included as part of the U.S. standardized approach (for example, with regard to the calculation of the capital charge for operational risk).

Under the proposal, banking organizations that are not "core banks", and therefore are not required under the U.S. risk-based capital rules to apply the most advanced approaches for credit and operational risk, would have the option to apply either the standardized approach or remain under the existing Basel I framework. Throughout the U.S. Basel II rulemaking process, the Institute has supported optionality, and we plan to express our strong support for this aspect of the proposal in the Institute's comment letter.

A significant issue for internationally headquartered banks with respect to implementation of the Basel II Accord in the United States has been the approach taken to the treatment of their U.S. intermediate holding company subsidiaries as “core banks.” Specifically, status as a “core bank” is determined on the basis of the consolidated assets of the intermediate U.S. holding company, so that the most advanced approaches would apply as a result of there being a significant nonbank subsidiary (such as a securities broker-dealer) of the holding company even if the size of the holding company’s U.S. bank subsidiary is significantly below the “core bank” threshold. However, under the final U.S. Basel II rules international banks faced with having to apply the most advanced approaches because they have such a U.S. intermediate holding company can apply to the Federal Reserve for an individual exemption. Notably, the proposal solicits comments on whether “core banks” should be given the option to apply the standardized approach rather than the most advanced approaches. If adopted, this option would provide such international banks an alternative to seeking an exemption from the Federal Reserve.

INSTITUTE COMMENTS ON PROPOSED REVISIONS TO THE REGULATIONS RELATING TO CFIUS NATIONAL SECURITY REVIEWS AS THEY AFFECT INTERNATIONAL BANKS’ DIRECT INVESTMENT AND LENDING ACTIVITIES IN THE UNITED STATES

The Institute filed a comment letter on June 9th regarding the Treasury Department’s proposed regulations implementing the amendments to the Committee on Foreign Investment in the United States (CFIUS) review process enacted in the Foreign Investment and National Security Act of 2007. (The comment letter is available at <http://www.iib.org/associations/6316/files/20080609FinalCFIUSLetter.pdf> .)

While supporting the basic approach and architecture of the proposed regulations, which reflect careful consideration and balancing of national security interests and the traditional economic strength and commitment to free markets of the United States, the Institute raised several concerns regarding potentially unintended consequences and difficulties that arise from the proposed regulations from the perspective of internationally headquartered financial institutions engaged in direct investment or lending in the United States. These concerns focus in particular on the potential impact the proposed regulations would have on international banks’ corporate and acquisition finance, merchant banking and minority investment activities.

The Institute’s submission addresses concerns regarding the proposed regulations’ treatment of “negative pledge” clauses in loan agreements, debt previously contracted (DPC) transactions and minority private equity investor shareholder rights, as well as the question of whether acquisitions of financial institutions would be treated as potentially involving “critical infrastructure.” In addition, the letter addresses other concerns regarding certain additional aspects of the proposed regulations – specifically, the treatment of convertible instruments and suggested means to reduce both the number of notifications likely to be triggered by the regulations and the burden of making a notification.

CONGRESS, IRS CONSIDERING CHANGES TO QUALIFIED INTERMEDIARY AND OTHER REPORTING RULES

As widely covered by the general press over the past two months, the U.S. government has stepped up efforts to curb perceived abuses and shore up certain loopholes in the cross-border U.S. withholding tax arena, principally involving international banks that act as Qualified Intermediaries (QIs).

In July, two Congressional committees held hearings on these developments, and several reports were prepared in that connection. In addition, the IRS has indicated that it is evaluating compliance gaps in the relevant rules. These developments will almost certainly result in a tightening of the reporting obligations and oversight of internationally headquartered financial institutions. Even before any proposed

changes to existing rules are implemented, member banks may wish to examine their U.S. client-related activities and procedures to determine whether any modifications are appropriate in light of these developments.

Among possible changes that are being considered are the following:

- Require QIs to determine and report to the IRS the U.S. beneficial owners of shell companies, trusts and similar intermediate vehicles
- Require QIs to report to the IRS the U.S. beneficial owners of **all** accounts and their income, even if they hold only non-U.S. securities or other assets and/or earn only income that is from non-U.S. sources and is not subject to U.S. withholding tax
- Require QIs to check client residence certifications against KYC and other available information
- Require more electronic filing of forms under QI program
- Expand the scope of QI audits and require accounting firms to report indications of fraud (which may be presumed in the case of a failure to treat U.S. owners of shell companies and trusts as beneficial owners) or other serious compliance issues

The Institute will be following these important developments and, to the extent it is able to do so, it will endeavor to provide input to the Congressional committees and the IRS regarding the practicability, administrability, efficacy and costs of any proposed changes to the existing rules.

**INSTITUTE REQUESTS THE TREASURY DEPARTMENT AND IRS TO ADDRESS
OPEN ISSUES WHEN FINALIZING TEMPORARY REGULATION
SECTION 1.882-5T INTEREST EXPENSE RULES**

In June, the Institute sent a letter to the U.S. Treasury Department and the Internal Revenue Service supporting the finalization of Temporary Regulation section 1.882-5T, dealing with the calculation of an international bank's deductible interest expense, which was released in August 2006 and is scheduled to expire in August 2009. (The letter is available at <http://www.iib.org/associations/6316/files/20080618Letter882-5.pdf>.) The Temporary Regulation contains several needed provisions, including (i) an increase in the "fixed ratio" to 95% and (ii) an election to use a 30-day LIBOR rate to compute excess interest under the adjusted U.S. booked liabilities method.

In addition, the Institute requested that in finalizing the Temporary Regulation, the Treasury Department and the IRS also address several important aspects of the calculation of interest expense under regulation section 1.882-5, including:

- providing for the direct tracing of interest expense on securities repo (sale and repurchase) and securities lending transactions, in order to address the often-uneconomic results that occur where the bank has a substantial portfolio of U.S. government or other securities that are financed (at virtually 100% leverage) through "sale and repurchase" (repo), or securities loan, transactions but is required to impute capital (and thereby lose the ability to fully deduct interest on these positions); and

- providing a mechanism whereby an international bank may elect to make a contemporaneous identification of (i) an interbranch loan, made by its U.S. branch, that is denominated in a non-U.S. dollar currency and (ii) either (A) a discrete third-party borrowing by the U.S. branch in the non-U.S.-dollar currency that funds the interbranch loan or (B) a discrete third-party U.S. dollar-denominated borrowing by the U.S. branch and a foreign currency hedging transaction that together provide the funds for the interbranch loan, as an integrated position, in order to avoid potential whipsaw results for taxpayers and the IRS under the current rules, which ignore the interbranch loan but require the taxpayer to recognize currency gain or loss.

The Institute understands that its letter was favorably received by the IRS.

**TREASURY DEPARTMENT ACCEPTS INSTITUTE'S CRITIQUE AND
NARROWS SCOPE OF REQUIREMENT OF CONSISTENCY BETWEEN
INCOME TAX TREATIES AND U.S. DOMESTIC LAW**

The U.S. Treasury Department has released Technical Explanations to the new tax treaties with Bulgaria, Canada and Iceland that omit the controversial statements that are in last year's Technical Explanations to the new treaty with Belgium and treaty protocol with Germany regarding the so-called "consistency rule." Under the consistency rule, a taxpayer may not take an inconsistent position in claiming benefits under the treaty and U.S. domestic law (the "consistency rule").

In the Belgian and German treaty Technical Explanations, the Treasury Department had significantly expanded the consistency rule in a manner that would adversely affect internationally headquartered banks and other financial institutions that are qualified residents of countries with which the United States has an income tax treaty and that operate in the United States through branches or other "permanent establishments" ("PEs"). In particular, those Technical Explanations would preclude such taxpayers from claiming certain exemptions or other benefits under the Internal Revenue Code if they claim the benefits of the tax treaty so as to limit their U.S. tax liability in respect of income that is "effectively connected" with a U.S. trade or business (ECI) to the amount of profits that are "attributable" to the U.S. PE.

As previously reported, the Institute expressed concern regarding the new and expanded view of the consistency rule, and discussed those concerns with the Treasury Department and Congressional staff members.

In response to the Institute's concerns, the new Technical Explanations omit entirely the expanded interpretation of the consistency rule, but do not provide additional guidance as to how the rule might be applied under the new treaties, which adopt the OECD approach for attributing profits to PEs. We expect that further guidance may be issued in the future.