CONSTRAINTS ON BROKER-DEALERS OPERATING
OUTSIDE THEIR HOME COUNTRY

Richard N. Miles

MR. HAWES: We will now hear from Richard Miles. His topic is one, I guarantee you, that no law professor in the U.S. could adequately cover. Richard deals with this problem every day of the week, and he can give us an interesting survey of the constraints on broker-dealers—for example, Merrill Lynch—operating outside their home country.

1. BROKER-DEALERS OPERATING ABROAD

MR. MILES: I have been asked to say a few words about the legal constraints on broker-dealers (presumably based anywhere in the world) when they operate abroad (presumably anywhere else in the world); and I have to admit that at first I found such a broad assignment a little daunting. However, it seems to me that one could at least begin to get a handle on this subject matter by asking three basic questions: (1) What broker-dealers are we considering? (2) Where in the world would they want to go? and (3) What would they really want to do when they got there?

A. Which Broker-Dealers?

In the important financial centers, broker-dealers probably play the principal role in the securities business in only the U.S., England plus the Commonwealth, and Japan. This is true primarily because only in these countries have they been effectively isolated and/or protected from the banking community. On the Continent, broker-dealers have little, if any, such protection. True, agents de change do have a monopoly on the Paris Bourse, and they also have a public customer base. But because they are prohibited from acting as a dealer and have not been permitted to incorporate until recently, they have not been able to accumulate the capital needed to develop a large retail base; and it has been estimated that perhaps eighty percent of French stock exchange orders are transmitted via the banking system. In Germany, carrying customer accounts for the purpose of executing securities transactions is, as a matter of law, exclusively a banking function. In the Netherlands, both banks and brokers can be members of the Amsterdam Exchange, and the brokers have managed to stay reasonably competitive. Nevertheless, overseas operations tend to be pretty much the province of the commercial banks.

Of course, these so-called universal European banks have foreign branch networks themselves. These, together with the foreign branches of the larger English, American, Canadian, and Japanese banks (which all tend to become universal once they cross their frontiers), obviously play a major role in the international securities business. Although many of the legal and regulatory restrictions on broker-dealers (set forth in some detail in the Appendix to this
Chapter) undoubtedly apply also to the securities-related activities of bank branches or agencies, I will address these comments only to the activities of those non-bank broker-dealers whose off-shore locations you will find listed in Exhibit 1. From this listing you can see that I have already managed to reduce the broker-dealer home countries to only four: the U.S., Canada, England, and Japan.

**Exhibit 1: BROKER DEALERS OPERATING ABROAD**

<table>
<thead>
<tr>
<th>FOREIGN LOCATIONS</th>
<th>United States (NYSE)</th>
<th>England (Stock Exchange)</th>
<th>Japan (Licensed Securities Companies)</th>
<th>Canada (Investment Dealers Assoc.)</th>
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<td><strong>37</strong></td>
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B. Operating Where?

The next opportunity to pare the subject matter brings us to Question #2 and the potential host countries to which these broker-dealers would be interested in going. The question of which countries are interesting depends, of course, upon the availability in each jurisdiction, or its multinational sales region, of prospects for the opening of profitable accounts. In this respect, the primary determinant—and probably also the most important constraint on broker-dealer operations throughout the world—is exchange control. It is understandable, perhaps, that the last thing that a developing country with a critical need for local investment, or an autocratic government fearing the flight of capital, would want in its midst is a brokerage office dedicated to the sale of foreign investments. It follows that foreign securities firms are not found very often in such countries or, absent special circumstances, even in developed and more stable countries where governments still choose to maintain significant controls over the wealth of their residents.

The more unlikely locations on the Exhibit 1 listing of foreign broker-dealer offices tend to be small, special purpose operations; often, in the case of the U.S. firms, handling exclusively commodity-futures brokerage to meet the hedging needs of authorized trade houses or government purchasing agencies. Other locations may be solely investment banking offices, set up for the purpose of developing local or regional financings. You will also find a number of offices in some developed countries with at least the apparatus still in place for exchange control. However, in the Netherlands and Belgium, present practice creates no significant detriment to foreign portfolio investment. In Japan, foreign investment can be made freely, provided it is done through authorized securities companies. In France and, until recently, England, exchange control continues to operate; but the presence of large and often quite wealthy expatriate populations (which are not internal for exchange control purposes) have made retail broker-dealer branches feasible and potentially very profitable.

(1) Initial entry techniques

My own firm has found commodity services by far the most useful door-opener. "Commodity only" offices were our initial and, in some cases, remain our only operations in Singapore, Seoul, São Paulo, and Taipei. Our second and, so far, successful attempt in Australia is primarily a commodities venture; and, at various times in its history, our Manila office has serviced only commodity customers. On occasion, these offices may assist their firms in obtaining underwriting or syndicate positions in local or regional financings. A next step may be permission to service the securities accounts of those U.S. citizen or other alien residents who can maintain off-shore accounts. It may then be possible to develop limited business with local institutions who may invest some of their assets abroad. In Greece, we have assisted in organizing a local mutual fund under an exchange control provision permitting a portion of its portfolio to be invested overseas. Spanish mutual funds have similar privileges, as did the English unit trusts. Eventually, the host country may find itself in a position to do away with controls altogether—as was the case in Singapore—at which point it is hoped that the local office, having been there all along, will find itself well positioned competitively.
(ii) U.S. neighbors

In any event, these exchange control considerations, at least insofar as the securities business is concerned, do serve to reduce the list of important host countries to, perhaps, a dozen or so (plus the oil producers), and it can be seen from Exhibit 1 that representation appears to be achievable in most of them. There are, however, two notable exceptions. Curiously (but perhaps not so curious) these are the closest neighbors of the U.S.: Mexico and--aside from a few grandfathered firms--Canada or, at any rate, the key province of Ontario.

Although the Mexican peso is freely convertible, and the authorities raise no objection to Mexican residents opening investment accounts while abroad, they very much discourage the active solicitation of such accounts within Mexico. Any branch activity or direct participation, even a minority interest, in a Mexican financial institution would require the approval of the Banco de Mexico; and I was advised only last fall that no such approval would be forthcoming at this time.

Canada, of course, now presents the would-be visitor with two hurdles: federal (the Foreign Investment Review Agency) and provincial. The provincial restrictions are a mixed bag, but currently there is an absolute bar insofar as Ontario is concerned. Canada may be a useful starting point for consideration of question number three; and that is, what do foreign broker-dealers really want to do when they enter a given jurisdiction? It was only in Canada that a really significant effort was made by a broker-dealer to enter a foreign securities market for the purpose of selling local securities to local residents in direct competition with the major factors in that industry. That effort, of course, commenced with the acquisition of Royal Securities by Merrill Lynch. Although Merrill Lynch Royal Securities is now a viable business, I would not be giving anything away by suggesting that our management undoubtedly had some second thoughts about this venture during the early going or by suggesting that our acquisition was at least to some extent responsible for the closed door policy which subsequently evolved.

C. What Kinds of Activities?

Much has been said about the need for reciprocity in the growing internationalization of the securities business. To many this has been understood to include the free right of entry to local markets around the world by multinational securities firms. At the business level, however, very few securities firms--including my own since its Canadian adventure--have shown much interest in across-the-board competition in foreign markets. To them reciprocity has more often been identified with the highly valued reciprocal business which they receive from those markets; business which, in all likelihood, would not be forthcoming if they entered those markets on a competitive basis.

Many firms with established positions in attractive investment markets enjoy a significant inflow of orders from abroad. When their orders into foreign markets, be they for customers or for their own arbitrage account, are more than off-set by reciprocal orders from local banks and brokers, they must give careful considerations, indeed, before they take any action that could be construed as direct competition with their best customers. Nevertheless, as you can see in Exhibit 1, there are 219 New York Stock Exchange member offices in
thirty-one foreign countries; members of the Stock Exchange in Lon-
don maintain thirty-seven offices in twelve countries; and Japanese
securities companies have seventy overseas offices. What are all
these offices doing if they are not competing in the local markets?
As to the U.S. firms, I think it would be safe to say that they are
competing with each other and with the U.S. stay-at-home firms for
a larger slice of the order flow coming from those locations into
the U.S. markets. To a lesser extent they compete in the interna-
tional bond market.

Even after a securities firm has concluded that its primary
effort in a foreign country will be to drum up business for the ex-
changes back home, it has yet another marketing decision to confront.
Where it services the accounts only of local banks and brokers or
those financial institutions that are so big that they would bypass
local intermediaries and deal directly with the home market, the
firm is obviously not competing with its best customers. On the
other hand, if it should decide to go to the local public in order
to reach the end investor, order flow from these intermediaries
should be expected to decline. This marketing question is obviously
a critical one. For the U.S. firms, it became a much more difficult
decision after the demise of the minimum commission; since the in-
termediaries, who collect end-investor orders and come to the U.S.
markets in size, obviously can negotiate commission discounts that
individual investors would not be able to command.

2. THE REPRESENTATIVE OFFICE

In any event, the drumming up of business for the home market,
be it from local banks and brokers or from the end investor, is
usually carried out through a legal vehicle; or perhaps more accu-
rrately, a legal fiction known as a representative office. Although
primarily a fiscal concept, the representative office, or service
company structure, has also proven useful to many securities firms
in avoiding local banking and broker-dealer regulation. In the tax
context, a representative office encompasses virtually any activity
that does not create a taxable permanent establishment of the for-
eign business. A representative office may be either a branch or a
separately incorporated subsidiary. It can be a base for business
promotion and solicitation, and it is usually permitted to provide
services to both the foreign concern and that concern's local cus-
tomers. The representative office and its employees, however, should
have no authority to bind their home offices; and they should play
no direct part in the conclusion of transactions for the foreign
concern or its customers.

A. Tax Arrangements

Although it is arguable that under some tax regimes or trea-
ties a representative office has no local income tax liability what-
ever, in most jurisdictions it is the practice to negotiate a tax
regime with the fiscal authorities, providing for a notional taxable
profit expressed as a percentage of the representative office's
expenses—usually in the range of five to ten percent. The documen-
tation would consist of an operating agreement whereby the home office,
or parent, agrees to compensate the representative office for its
services through a fee measured by agreed-upon expenses plus the
negotiated percentage. My own firm has been successful in nego-
tiating such arrangements in all of its foreign locations with the exception of Austria, Italy, and Venezuela. In these countries various income formulas based on commissions and credits generated by accounts serviced by those companies have been utilized.

These expenses-plus arrangements do not necessarily result in lower taxes. There is no opportunity for carrying forward start-up losses; and it well may be that significant local taxes are incurred on what would prove upon analysis to be a losing operation. Nonetheless, chronic losing operations are not really tolerated in most jurisdictions, and the expenses-plus regimes have the great advantage of simplicity. Local auditors need only certify the expenses and add on the profit percentage. Before concluding such an arrangement, however, firms would be well advised to analyze the impact of local value-added tax where applicable, as VAT of fifteen to twenty-two percent on the entire service fee would be a rather unpleasant surprise.

B. Activities Not Triggering Regulatory Controls

On the regulatory front, the arguments that support the absence of a permanent establishment are often successfully used to claim that, as a matter of law, no broker-dealer or banking activity is being conducted in the local jurisdiction. Although it is conceded that accounts are solicited by the local office, they are said not to be accepted there, but merely introduced to the off-shore account carrier—which may either accept or decline them (usually it accepts). By the same token, although orders are solicited, they are neither accepted nor acted upon, but merely transmitted to the foreign place of execution. Statements, confirmations, margin calls, and other notices are said to be issued not locally but received from the off-shore securities firm and simply transmitted to that firm's customers.

In short, the local representative office is characterized as nothing but a solicitation base and a communications facility, retained by the foreign securities firm to promote its business and make it more convenient for local customers to communicate with their broker. These customers are in privity of contract with the home office entity, and account documentation should reflect this relationship. New account forms should also be consistent with the proposition that the accounts are only being introduced. Above all, customer notices and correspondence must be carefully monitored to avoid the suggestion, especially by an employee's use of the first person, that the actual securities firm is present in the local jurisdiction. When using local letterhead, it must be the home office that makes a correction or credits an account, not "we". My own firm was subjected to a full scale investigation by the German Banking Commission largely because the Commission came into possession of a letter written by an account executive, advising a customer that his account had been transferred from our London to our Frankfurt office rather than advising him that the account had been transferred to a New York ledger number for accounts serviced by the Frankfurt office. Of course, carrying accounts is banking in Germany.
C. Home Country Constraints

If we accept the proposition that most of these broker-dealer foreign offices are primarily bases for the solicitation of orders coming back to their home markets, it should be noted that often it is the home country's constraints that prove to pose the more serious problems in the development of off-shore business. Dividend and interest withholding taxes around the world are an obvious example. The Non-Resident Alien Estate Tax raises very serious marketing and ethical problems for the U.S. firms when they try to talk non-resident aliens into transferring their accounts to a U.S. custodian. Many of them go so far—doubtless to the horror of the SEC—as to actively encourage the establishment of foreign personal holding companies, not to achieve anonymity but to avoid substantial and unnecessary estate tax liability.

The perception of many investors that a U.S. custodian cannot offer an adequately confidential customer relationship is another major problem for U.S. brokers in the development of foreign business. The investments in U.S. securities are probably made in any event, but the orders come to the U.S. markets through foreign intermediaries who can offer, these investors think, the confidentiality they require. As I have noted, such orders are subject to pretty deep discounts.

In the Appendix that follows this Chapter, I have made some notes about the general ground rules and some areas of peculiar difficulty in many of the countries that appear to be of interest to foreign securities firms. I have not included the tough exchange control jurisdictions where broker-dealer offices, if any, must be of the special purpose variety. These include Greece, Italy, Spain, Portugal, Austria, Israel, Korea, Taiwan, the Philippines, India, much of Latin America (with the exception of Venezuela and Argentina, where broker-dealer representation is permissible) and, as noted, Mexico.

The oil producing Arab countries, as well as Lebanon, have no exchange restrictions and there are no particular regulatory difficulties with representative offices, other than in Saudi Arabia (which is more or less closed) and Kuwait (whose 1970 Securities Ordinance effectively blocks the sale of mutual funds and includes certain other troublesome provisions). Under the prior regime in Iran, minority participation in broker-dealer operations, including representative activity, was achievable. For the U.S. firms, at least, any interest in a visible presence in the Republic of South Africa appears to have been shelved.

3. THE GROWTH OF SOME INTERNATIONAL MARKETS

A. The Equity Market

When I read over these notes it seems that this commentator, at least, does not sound very bullish about the imminent internationalization of the securities markets. We do have some reservations, but more with regard to the equity portion of the markets than with the money markets. This is understandable and there are a number of reasons for it.

The first reason is that equities are, after all, traded largely on stock exchanges; and in most financial communities the
exchanges still constitute the entrenched establishment. The second is that an investor or trader really has to know a lot more about an issuer to be comfortable with its shares than would be the case for a debt instrument. The kind of information about these issuers that investors expect and brokers must provide in the U.S. is simply not available in many jurisdictions. The third is that governments in most jurisdictions tend to be much more protective when it comes to the ownership of their industries than they are about their debt. That concern is understandable. There are limitations on foreign ownership in Japan and in key industries in the U.S. Recently talk about removing our withholding tax has focused only on interest and not on dividends.

MR. FRIEDMAN: Do you think it would be healthy for American companies to be raising equity abroad? Is that something we should be taking affirmative steps to encourage?

MR. MILES: Yes, through the Eurobond market.

MR. FRIEDMAN: Equity?

MR. MILES: Oh, equity. I think it would be tough marketing; certainly, the utilities would find it difficult. They are return-related instruments, and if you are looking at a thirty percent withholding tax. . . .

MR. Friedman: But if we wanted to encourage it, then we would start looking at equities the way people are looking at debt securities and perhaps drop the withholding tax.

B. The Money Market

MR. MILES: The money market part of the international markets is becoming a lot more international. I think it is because money is being recognized as a commodity; and, as I have said, the commodity trade has considered its market as international for a long time. With today's widely fluctuating exchange and interest rates, no one contemplating a large financial or commercial transaction can afford to ignore this exposure. The result that we have seen has been a powerful market demand for nearly instantaneous execution services in both debt and forward exchange markets, as well as in currency and financial futures.

This demand is really not so much for an around-the-world market as it is for an around-the-clock market. Few seem prepared these days to wait until tomorrow to find out whether or not their order was filled and at what price; and the response of many dealers has been to set up trading desks in the Far East and elsewhere around the world. Perhaps I could close these remarks by saying, "Let us hope the equity markets will follow," but I suspect it will take a few more years.

C. An Around-the-Clock Market

MR. HAWES: Thank you Dick. Chuck, did you want to comment on this concept of the around-the-clock trading markets, and arbitrage, and what questions that raises?
MR. MILES: The interesting thing about those markets is that they are growing every day. The U.S. firms and the foreign firms are basically trading around the clock, and that means around the world in the sense that they are passing the book.

MR. NATHAN: Chuck, I think really they are not passing the book. They are passing the authority to trade the book.

MR. NATHAN: Okay. They are trading out of Hong Kong and out of Europe, perhaps against a book physically located in New York, but they are trading it around the clock.

In conversations I have had with the people who are doing this, the interesting thing is that they see very few legal restraints or inhibitions on their actions, and it does not seem to matter if they are trading in American equity securities. I understand that after the close of the market there is a fair amount of trading going on in Europe of American equity securities in a third market, if you will, or a gray market that has a large participation by American brokerage firms. That is also happening in the Far East. European equities are being traded to resell back in New York or to resell to other institutional customers somewhere else in the world. This seems to be happening in some sort of gray market or third market that is unregulated. The key is that everybody waits until the primary market closes down, and then they trade like mad and have a wonderful time.

On the other hand, I think the participants in these markets do recognize that there is a principal market for virtually every security and that the principal market drives the price. I specifically asked one trader, "If a stock closes on the Amsterdam market at whatever price you want to name, can you manipulate it overnight, and get it up there in the morning, and make a nice little killing?"

And he said, "No. The principal market is where the supply and demand really is. That is where the liquidity is, and this is especially true for U.S.-based equities. Anyone who tries to play games is going to get his head handed to him sooner or later. We are just guessing where the market is going to open, and we act as if we were trading while the market is open. We trade on an unregulated basis where we do not have to worry about access; it is just good old-fashioned dealer trading."

This system seems to be picking up a lot of steam, and the traders, at least, are comfortable with it. Looking at it from the U.S. point of view, I do not see any great problems with it, as long as we do not run into our 1933 Act fence by trading European issued securities into the U.S. before it is legal to do so. The hour of the trade does not matter; the SEC does not shut down at five. There is no time-of-day qualification on SEC constraints. We are talking here in terms of market, and access to market, and who is doing what; and now, it seems, things are happening on a twenty-four hour basis.

MR. MILES: Well, there certainly are some problems--fiscal problems if nothing else. When you have one inventory being traded by three or four different trading desks, how you find out the location of the attributable income is a nightmare.

And there are regulatory problems. Right now we are talking
to people in the Ministry of Finance in Japan about a trading desk in Tokyo, and they go right to the heart of the matter. They say, "Is not the U.S. broker-dealer, through an agent, already carrying on an unregistered business in Japan?" But they are still considering the matter. We are talking back and forth to see if we cannot come to some accommodation. As soon as you transfer the authority to trade inventory, you have a regulatory problem in the place the inventory is traded. So, there are real problems. As to money market securities, the problems already exist today; they are not "coming".
APPENDIX XVI

RESTRICTIONS IMPOSED BY SPECIFIC COUNTRIES

Australia

Representative office tax regimes are acceptable, and accounts may be introduced and orders passed to an off-shore account carrier, but only, as in England, by holders of Securities Dealer Licenses which are issued by the Commissioners of Corporate Affairs for the various Australian states under their respective Securities Industry Acts. The posting of bonds is required, but these licenses are generally available to responsible firms.

Upon approval of the Reserve Bank, Australian residents may undertake portfolio investments overseas up to the following annual amounts:
1. **Individuals** - A$40,000, including up to A$10,000 in eligible fixed income investments (not short term or issues with less than 1 year to run).
2. **Substantial private companies** - A$250,000, including up to A$100,000 in eligible fixed income investments.
3. **Listed public companies and institutions** - A$2,500,000, including up to A$1,000,000 in eligible fixed income investments.

The annual period runs from July 1 to June 30, and, upon approval, additional amounts may be invested in each such period. Once an overseas portfolio investment has been made, it may not be dealt with without further approval. If frequent switching is intended, the Bank will grant general authority subject to periodic reporting requirements. Proceeds of sales and income may be held for reinvestment abroad for up to one month and, if not reinvested by then, must be repatriated.

Members of an Australian stock exchange must be natural persons carrying on business in partnership. With committee approval, they may have an interest in or be a director of a limited liability company carrying on business outside Australia as a member of a "recognized exchange" in accordance with the rules of that exchange, but they may not otherwise be a director or have an interest in any other company or firm (other than their own partnership) engaged in the stock brokerage business. There has been no case of a representative of an overseas securities firm successfully applying for membership.

Membership on the Sydney Futures Exchange is available to foreign firms, who thus are free to compete in the local market for commodity futures. However, the passing of orders to foreign commodity exchanges, other than for the commodity trade, is not feasible for resident customers since they would not ordinarily receive approval from the Reserve Bank to meet overseas margin calls.

Belgium

Belgian residents are free to invest in foreign securities and carry investment accounts abroad without prior approval. There is a requirement to report to the Belgo-Luxembourg Exchange Institute (IBLC) any foreign exchange transaction needed to obtain the required currency (which must be done in the free or financial franc market). These reports need only indicate the details and the reason for the conversion, and they are usually filed by the banks through which the transactions are made. There is no requirement to repatriate proceeds, and reinvestments need not be reported.

Representative office tax regimes are generally accepted. However, under the Belgian Commercial Code, it is illegal to receive orders to purchase or sell securities unless one is either a Belgian bank or an agent de change.
R.N. Miles / Constraints on broker-dealers outside their home country

and the latter must be an unincorporated Belgian national. The Code further defines the receipt of an order as follows: "to collect (recueillir) such orders in Belgium, either for one's own account, or for passing them on, in any capacity whatsoever, in Belgium or abroad, even without a personal responsibility in the transaction". Nevertheless, although it certainly would appear from the foregoing that Belgium was one jurisdiction where order passing representative offices would not be sanctioned, what amounts to an administrative tolerance has permitted their successful operation in Belgium for more than a decade. The collection and passing of commodity futures orders are permitted provided the office registers with a Commodity Exchange Commission (still in existence despite the fact that there are no longer any Belgian exchanges) and complies with certain confirmation requirements.

Belgium has very stringent laws dealing with colportage and demarchage, which severely restrict the ability of representative offices to solicit customer accounts. These are covered in detail in the notes on France.

Canada

There are no restrictions on foreign investment by Canadian residents. Representative office tax regimes can be negotiated, and a number of foreign broker-dealer branch or subsidiary representative offices have been established in the various Canadian provinces.

At present, however, any foreign broker-dealer wishing to open up a place of business in Canada will first require the clearance of the federal Foreign Investment Review Agency, which must certify that the proposed operation will be of "significant benefit" to Canada, presumably by providing needed services not available from the existing securities industry. Our present advice is that, at best, such clearance would be less than automatic. Even having cleared the federal hurdle, a foreign concern would then face a more difficult one if it were interested in the key province of Ontario and membership on the Toronto Stock Exchange.

Regulations under the Ontario Securities Act, promulgated upon the 1970 Moore Report recommendations, have effectively blocked the registration of foreign controlled broker-dealers in Ontario other than those originally grandfathered in 1971. Under the present Regulations (131/135), new registrations are limited to applicants no more than twenty-five percent owned by non-residents with no single non-resident having more than a ten percent interest. In addition, the renewal of grandfathered registrations (there are four still left, one of them under review) is subject to Commission review of any changes in ownership and capital as well as a finding that they provide a "material or unique service to Ontario investors not substantially available to those investors through other registrants". Although a 1979 report issued by the Securities Commission suggested a limited registration for foreign controlled firms that would permit them to act as a broker-dealer only with respect to transactions in foreign securities with Ontario residents and to the conduct of activities incidental to the sale outside of Canada of securities issued by Ontario entities, no action has been taken on those recommendations to date.

Merrill Lynch Royal Securities Limited, one of the grandfathered firms, carries its own customer accounts and deals with its U.S. parent only through inter-company omnibus accounts. We understand that those firms not carrying customer accounts and conducting only representational activities are nevertheless required by the Commission to maintain at their premises a full set of customer account records.

[47]
England

There are presently no exchange control restrictions. Representative office tax regimes are accepted, but any establishment carrying on or purporting to carry on the business of dealing in securities or wishing to distribute circulars containing invitations or information likely to lead to the purchase of securities must either obtain a Dealers License issued by the Department of Trade or be a member of a securities exchange or of an association recognized by the Stock Exchange in London.

Holders of a Dealers License must also register their individual salesmen, but most U.S. and Canadian broker-dealers have taken advantage of the licensing exception granted to members of the United Kingdom Association of New York Stock Exchange Members or the Association of Canadian Investment Dealers and Members of the Toronto and Montreal Stock Exchanges in Great Britain. Both associations are run by U.K. resident committees, and, in general, their members face little in the way of regulatory difficulties in carrying out either representational or dealer activities. Association members are entitled also to reduced Stock Exchange commission rates on their larger trades, which, although available to the public customers of Exchange members, are not granted to most other financial institutions, including holders of a Dealers License. Prior to the unwinding of exchange control, both members of the Exchange or its associations and holders of a Dealers License were also accorded the status of an authorized depository of the Bank of England, which permitted them to conduct certain cashiering activities and to carry or service internal accounts wishing to go through the premium market to make foreign investments.

Admission to membership on the Stock Exchange is at the full discretion of its Council. Although there have been a few foreign individual members, no banking institutions or overseas brokers have been admitted to date. Corporate membership is permitted, but non-member interest in the capital of such a company is limited to a ten percent holding by each non-member shareholder, including his associated companies and family, and all directors must be members of the Exchange and assume personal liability.

The term "security" is narrowly construed as meaning shares, debentures (or rights therein), U.K. and non-U.K. government bonds and rights under a trust deed where the relevant property consists of securities. Circulars with respect to mutual funds or unit trusts may not be distributed unless approved by the Department of Trade, nor may circulars dealing with partnership interests (such as oil and gas ventures) or other profit sharing schemes. Until recently, security options were unattractive to U.K. taxpayers since they were considered wasting assets. However, security option transactions are now treated as capital events. Commodity futures remain unattractive as all gain is treated (under Case 6) as ordinary income which cannot be set off against other losses.

London, of course, is the primary center of the international bond or Eurobond market, and holders of a Dealers License and association members, as well as the banks, can deal freely in these securities as well as in a more modest third market for international equities. Most of these dealers are members of the Association of International Bond Dealers, whose rules as to settlement and the like, as a practical matter, tend to set the industry standards despite the fact that it has no legal sanctions available.
France

French residents for exchange control purposes include all French companies, branches of foreign companies and, as to individuals, resident citizens and foreign nationals after they have been resident for two years. Foreign portfolio investments may be made by such residents and carried in accounts abroad only with funds legitimately held abroad. They include:

1. Funds or the proceeds of investments which were held abroad on November 25, 1968, the date when exchange control regulations were re-imposed after a period of suspension during the de Gaulle regime.
2. Funds or the proceeds of investments held abroad by an individual when he was a non-resident.
3. Funds transferred abroad by a resident under an authorization of the Banque de France. The commonest of these items would be funds of foreign nationals working in France, who are permitted to export their earnings upon proof of payment of French income taxes.

Income on these securities must be repatriated through an authorized bank or agent de change.

French residents may also purchase listed foreign securities with internal funds provided they do so through an authorized bank or agent de change and the securities are held by those entities in their name or in the name of their foreign correspondent.

It follows then that the representative offices of foreign securities firms (which are acceptable in France) are limited to servicing only those French resident customers who have funds legitimately abroad, and that they must deal through French intermediaries with respect to foreign investments made with internal funds.

Foreign controlled banking institutions are permitted, but to be economically feasible there would have to be a reasonable prospect for successful banking or investment banking operations. An agent de change is a semi-public exchange or bourse official appointed by the government and must be a French national. Originally, an agent de change could carry on business only in his own name. It is now possible for agents de change to carry on business through a limited partnership or corporation. However, there is a requirement that at least one-quarter of the corporate capital be held by one or more agents de change.

Both France and Belgium have very stringent laws with respect to colportage (the door-to-door selling of securities for immediate settlement) and demarchage (the regular solicitation of securities transactions at a residence, place of work, or public place, or by mail or telephone). Colportage is forbidden altogether, and demarchage is permitted only by banking institutions and by agents de change and their solicitors, all of whom are subject to specific government regulation. The French penal provisions run from one to ten years imprisonment and up to 180,000 francs in fines, and civil actions may be brought for damages or recision. These laws severely limit the ability of the representative offices of foreign securities firms to develop business. Strictly speaking, all business solicitation should be limited to the banks and agents de change themselves, those prospects who come to the representative offices of their own volition, and prospects who have independently requested information about the opening of an account. In practice, most brokerage offices in these jurisdictions take the position that, once an account has been opened, it is all right to provide that customer with investment suggestions by phone or at his home; but on that score the provisions of these laws give us very little in the way of comfort.
Germany

There are no restrictions on foreign portfolio investment by residents, but German investors appear to have a perhaps understandable preference for investing in their own economy, and, as measured by NYSE activity, purchases of foreign securities are relatively modest compared to other countries in Western Europe.

Representative office regimes are achievable, but their activities are rather more circumscribed than in most other countries. Under interpretations of the German Banking Commission, the mailing locally of confirmations or contract notes and any cashiering functions carried out on behalf of the foreign account carrier are considered prohibited banking functions. The confirmations, therefore, must be mailed from outside Germany, and German representative offices can play no direct role in the settlement of transactions through the transfer of funds and securities.

The German gaming laws represent a significant restraint on certain types of securities transactions commonly conducted in other markets. Although most of the case law has to do with commodity futures (other than bona fide hedging by trade houses), most commentators would extend the gaming prohibitions to put and call options on securities, and a 1978 supreme court case even went so far as to hold that a short sale was an illegal wagering contract.

Essentially, this line of cases takes the position that options, speculative futures contracts, and short sales lack commercial reality and, upon analysis, amount to no more than bets on the market for the underlying security or commodity. Unlike the courts in most of the common law countries (gaming law problems tend to be a Protestant phenomenon), the German rulings do not require the mutual intent of the parties to the contract not to exercise or take delivery. Nevertheless, a considerable amount of speculative commodities and option business is still conducted with German customers through representative offices and, I have been told, also through some of the German banks (warrants traded on the German exchanges enjoy a specific exemption). The U.S. brokers heretofore had taken some comfort from the understanding that although these contracts were not enforceable in a collection effort in the German courts, the customer was also barred from these courts in any action to get back his margin deposits. However, in the 1978 short sale decision (this was a collection case), the court held that the defendant was entitled to the return of his margin deposit, raising the spectre, subject to possible jurisdictional defenses, of customers throughout Germany selectively disavowing their losing trades.

The German Banking Law lists among those activities that constitute banking and require a banking license both the "agency securities business" and the "securities custody business", which when taken together make it pretty clear that it takes a bank to be an account carrying broker, although a dealer with no customer accounts could theoretically operate. Of course, there is no reason why a foreign securities firm could not buy or organize a German bank; at one time, Bache & Co. did have a German banking subsidiary, which was also a member of the Frankfurt Stock Exchange. However, the price tag is not inconsequential; minimum capital of DM6,000,000, the services of at least two senior German banking executives, and full compliance with detailed rules as to record-keeping and segregation. The German bank would have to carry its own customer accounts and, as I was once told by the Banking Commission, could not perform any representational services for the accounts of a foreign (i.e., non-supervised) entity. It would appear, therefore, that any decision to go the banking route to obtain access to the German securities markets would have to be predicated on the expectation of profitable banking operations as well.

Germany has a very comprehensive mutual fund registration procedure, courtesy of IOS, which effectively blocks the sale of most foreign funds. Part
membership interests (such as oil and gas or real estate deals) are not considered securities, and their marketing by a representative office would require the obtaining of a commercial license under Sec. 34(c) of the Trade Law.

Hong Kong

Hong Kong has no foreign exchange restrictions, and representative office tax regimes are available.

However, the Securities Commission, created by the 1974 Securities Ordinance, has taken the position that a representative office director or manager must register as a dealer, on behalf of his office entity, and that each account executive must also register as a dealer's representative. Since the Ordinance also imposes on registrants various record-keeping and segregation requirements appropriate only to account carrying dealers, there is obviously room for regulatory difficulties, especially should the Commission take the position that the off-shore account carriers are dealing in securities in Hong Kong through their agent and require them to register. However, to date the unavoidable non-compliance with these requirements by representative offices has resulted in no major confrontations.

Membership in either the Hong Kong or Far East Stock Exchange is available to responsible foreign securities firms, as is membership in the Hong Kong Commodities Exchange. Representative offices handling commodity futures orders and their personnel must also register under the Hong Kong Commodities Ordinance, which is also administered by the Securities Commission.

Japan

Prior to the amendments to the Foreign Exchange and Foreign Trade Control Law and the abolition of the Foreign Investment Law last December, Japanese residents, other than some 120 financial institutions licensed to operate foreign securities accounts, were obliged to obtain prior approval for foreign portfolio investments unless they acquired them through licensed securities companies which themselves had secured a blanket approval for handling such transactions from the Ministry of Finance. The larger Japanese securities companies, including those "branches" of foreign securities firms licensed as securities companies under the 1971 Foreign Securities Dealer Law, have obtained such approvals, and thus are free to solicit the Japanese public with respect to the opening of accounts on their books for the purchase of both Japanese and foreign securities. Since the Tokyo Stock Exchange rules permit membership only by Japanese entities, and since only branches of foreign securities companies can be licensed under the Foreign Securities Dealer Law, exchange membership would be technically blocked even if the December exchange control relaxations did allow a direct investment by a foreign securities firm in a Japanese company. On listed business, therefore, the foreign branches must go through Exchange members--presently at a fifty percent discount from non-member commissions. Otherwise, their participation in local markets is limited largely to the over-the-counter bond market, since by law all trades in listed securities must be "exchange transactions".

However, under present administrative practices, these licensed foreign branches can also service accounts carried by their off-shore parent or home office for non-residents, Japanese residents who are not resident for exchange control purposes (aliens, resident less than one year or less than five years with respect to unrepatriated assets), or those Japanese institutions that are permitted to have off-shore accounts. Unlicensed representative offices of foreign securities firms are also present in Japan, and presumably they can provide similar servicing to those customers permitted to have off-shore accounts.
Japanese securities companies are held stringently to those activities for which they are licensed: securities brokerage, securities dealing, and securities underwriting and distribution. They cannot be a commodity-futures broker and cannot deal in securities options, which under Ministry of Finance interpretation are not securities.

The Netherlands

With a few minor exceptions not relevant to most foreign securities firms, no approval is required for residents to invest in foreign securities or carry foreign accounts. A periodic reporting requirement at the discretion of the Netherlands Bank has not been administered for some time.

Representative office regimes can be arranged. However, the Amsterdam Stock Exchange, which performs various regulatory functions under the auspices of the government, requires a written undertaking from the representatives (i.e., representative office managers) of foreign securities firms to the effect that they will not solicit or take orders from Dutch private persons, corporations, or institutions who are not members of the Association of Amsterdam Stock Exchange Member Firms—which includes virtually all of the Dutch banks and brokers. The result is that these offices, as to their securities business, deal only with Dutch intermediaries, or with resident aliens, or non-resident customers. There are no restrictions on commodity futures brokerage.

Foreign ownership of a member of the Exchange is not prohibited. However, there is a good deal of reciprocal arbitrage business coming from the Amsterdam market; and, to date, foreign broker-dealer membership has been limited to the affiliated European Options Exchange.

Singapore

There are no restrictions on foreign portfolio investments by residents, and representative office tax regimes are recognized.

The Singapore Securities Commission has recently taken the position that representatives of foreign securities firms and their salesmen, heretofore exempted or, at least, overlooked, must now register under the Singapore Securities Industry Act of 1973. However, the Singapore Act is not potentially as troublesome as the Hong Kong Ordinance—or for that matter the similar Malaysian Act—in that its Accounts and Audit Sections, which include record-keeping and segregation requirements, are applicable only to a dealer who is also a "stock-broker", a term defined as a member of a Singapore Stock Exchange.

Membership on the Stock Exchange in Singapore is restricted to Singapore nationals and partnerships, although restricted licenses have been granted to two or three foreign firms which provide for access to the Exchange through members on preferred conditions. Merchant Banking Licenses are also available to foreign securities firms, who may then apply for a further Asian Currency Unit License which allows for dealing in the market for foreign-currency fixed-income securities (Asian-dollar market).

Switzerland

There are no restrictions on foreign investment, and representative offices are recognized routinely.

However, there is an informal understanding between the Swiss Banking Association and the foreign brokerage community restricting the solicitation
of Swiss residents other than through banking intermediaries. The U.S. firms are understood to be able to service resident U.S. citizens, and there is undoubtedly a certain amount of competition for the many non-resident prospects who come to Switzerland to conduct their financial affairs. There is no restriction on the foreign ownership of Swiss banks, but to date no foreign broker-dealer has acquired a controlling interest, although White, Weld & Co., Inc. at one time had a substantial indirect interest in Clariden Finanz AG, a Zurich banking house. It has been suggested that a controlling interest in U.S. hands could raise difficult questions with respect to U.S. disclosure requirements and the Swiss laws on bank secrecy and industrial espionage.

To do business in Zurich, a securities firm representative office must have in its employ an individual who holds a so-called "B" License issued by the Cantonal government. The licensee must be of Swiss nationality and have had management experience with a Swiss bank or other financial institution, and all holders automatically become "B" members of the Zurich Stock Exchange. Although this membership does not authorize that firm to trade on the Exchange (a privilege reserved to the "ring banks"), it does allow a fifty percent rebate on commissions.

In the late sixties and early seventies, Switzerland was a candidate, although possibly a reluctant one, to be a center for the conduct of the international bond business. Several major dealers set up trading operations in Zurich and Geneva with a view to better servicing the needs of the Swiss banking community, then believed to be the final resting place for close to eighty percent of the Eurobond float. However, changes in the Swiss Stamp Tax, effective July 1, 1974, and a tax court decision extending liability under the prior law made the professional bond trading business in Switzerland almost an assured loser, and the trading desks were moved to London.

United States

There are no current restrictions on foreign portfolio investments by U.S. residents.

Provided they meet the necessary federal and state (blue sky) regulatory requirements, foreign securities firms (including foreign banks as to their securities operations) are free to come to the U.S.; and, under the Securities Act Amendments of 1975, U.S. securities exchanges must permit access to any registered broker-dealer. Prior thereto, foreign controlled firms were not eligible for membership on the New York Stock Exchange, although a number had been admitted to regional exchanges. However, since the same amendments also did away with the U.S. minimum commission structure, the queue for foreign membership has not been long.

Apparently with a view to avoiding problems of incompatible U.S. and home market regulations with respect to record keeping and location, segregation, and the like, it appears that most, if not all, of the U.S. operations of foreign securities firms have been separately incorporated subsidiaries, dealing with their home market parent and its customers only through so-called omnibus accounts (i.e., intercompany accounts carried by each affiliate wherein the ultimate principal is not disclosed). Public accounts serviced by the U.S. entity are either carried on its own books, subject to U.S. requirements, or introduced on a disclosed clearance basis to other U.S. broker-dealers. Although these arrangements would appear to remove the parent company from the scope of U.S. regulation, a continuing problem has been the provision in the New York Stock Exchange Rules for Exchange inspection of the books of member affiliates where necessary to insure the financial stability of the member. As these rules obviously suggest a potential conflict with foreign law and practice—particu-
larly those relating to confidentiality—a recent compromise tentatively approved by the SEC provides for an independent inspection when a foreign government official or attorney certifies that the Exchange’s examination would violate that country’s law, custom, or business practice.

Although the law is not altogether clear, foreign broker-dealers with U.S. customers who choose not to have a place of business in the U.S. probably do not have a 1934 Act registration requirement, but they may well be subject to the Act’s antifraud provisions (See Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir. 1975)).