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The Problems: An Overview

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Securities regulation -- domestic and foreign -- has a technical fascination for the lawyer, whether he be a practicing attorney, corporate counsel, government regulator, or legal scholar. The intricate detail of the primary regulations and of their subsidiary byways provide opportunities for stimulating mental gymnastics. The piecing together of the various phases provides interesting occasions for experimentation, speculation, and analyzation.

Yet, a preoccupation with securities regulation which overlooks the setting can produce mere academic exercise. The need for an appreciation of the setting is all-important in examining foreign securities regulation. In considering United States securities regulation we do not need to devote any considerable time to forms of business operation, to the investment climate, or to other types of government regulation -- though our analysis suffers if we ignore these factors. As lawyers, or businessmen, we are so accustomed to these factors, and to the existing operations of the pertinent business entity, that we can take much for granted.

However, foreign operations present a different story. In establishing a new entity in another country, or in expanding an existing one, we must consider a range of problems which face a newcomer or an older guest in a host country. Many of these facets must be considered before grappling with the intricacies of securities regulation. Indeed, such consideration may actually point the way to avoid securities regulation entirely, while others affect the objectives inherent in issuing the securities in question.

It would be useful to have at hand a hornbook which catalogues and check-lists all of the problems inherent in foreign operations. However, the construction of such a hornbook would be an exercise in futility. The variety of operating conditions of the industry, the company, and the individual host countries is too great for a full description.

What I propose to do here is to provide a rough, impressionistic view of the contours of the underlying business-legal issues which come up, before one faces the problems of securities regulation. We shall consider, in order, the form of the venture, the investment climate, the financing institutions, corporate law, tax structure, other forms of government regulation, and patents and trademarks. Then, we shall turn to the influences of United States antitrust law -- an increasingly important element -- and our exchange controls. Finally, we shall briefly consider differences in the economic development of the host countries.

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FORM OF THE VENTURE

First among the questions which lawyers and businessmen must consider is what will be the form of the venture. When we talk about starting operations in another country, we think immediately of setting up a subsidiary corporation. In many instances, inadequate attention has been accorded to the possibilities of setting up branches, or of entering into a long-range agreement with a company established in the other country. Such arrangements may cover manufacturing, distribution, or both functions. They may provide for a buy-sell relationship, profit participation, license-royalties, or technical service fees. Frequently the issue of capital formation is faced before there is sufficient consideration of other forms of the venture, forms which require little, or no, capital.

I do not think anyone has worked out the whole gamut of the kinds of arrangements that can be made. My own experience suggests that there are no easy formulas. Solutions depend on careful analysis of the type of operation; methods of production and distribution; financial needs; importance of patents and know-how; availability of domestic "partners"; previously established market positions; and problems of establishing and operating branches.

INVESTMENT CLIMATE

Next is the question of investment climate. Consideration of regulation and of legislation is only the beginning of the investigation. What attitudes do the governments have regarding American investments within their countries? Do the governments have special provisions to induce a new enterprise to start an operation? Do they give it import permits? Do they provide advantageous loans? Do they provide land and buildings at low cost? Do they offer tax benefits?

Conversely, do the governments attempt to discourage the specific venture by holding back the tax and the financial benefits which are provided for competitors? Do they make it difficult to obtain building permits and necessary import permits for essential raw materials?

My own experience has been that one cannot rely on general descriptions of conditions in any country except as a guide to investigation. It is not possible to determine the conditions unless you actually get into negotiations. Preliminary negotiations may lead to advantageous financial arrangements through government or related institutions -- advantages which simplify problems of capital formation. Again, negotiations may reduce the capital requirements because they permit imports of parts and subassemblies, or because they indicate the advisability of purchasing such parts from competent domestic suppliers.

DOMESTIC FINANCING INSTITUTIONS AND REQUIREMENTS

An important element of the investment climate of a country is the structure of its financial institutions. Is there a readily available securities market? This, of course, is a key issue affecting the nature and extent of securities regulation.

What is the banking attitude toward long-term loans? Is there a government agency which makes long-term loans or purchases securities?

Does the host country require ownership-participation by nationals? Some countries maintain rigid, formal requirements. Others will, as a matter of administrative practice, refuse to issue necessary permits unless the pertinent departments are satisfied with the participation by nationals. No regulation tells you that it is advisable to take on influential nationals as partners in the enterprise, but experience indicates the need for such a procedure in order to obtain necessary permits.

After deciding to sell a majority-interest, or less, the problem of finding investors looms into view. If the country has a fairly efficient securities market, you can sell 51 per cent of the shares and maintain control because of dispersion of ownership. Contrariwise, you may have to contend with a majority owner or closely-knit group. At any rate, the choices may be influenced by the nature of securities regulation and expected future trends.

CORPORATE LAW

Several aspects of corporate law can exert an important influence on investment decisions. What are the forms of companies that are permitted? What is the nature of the capital structure which is required? Can you increase corporate capital easily, or do you need to obtain specific permission? Does the corporate form permit you to retain earnings and to declare dividends whenever you choose? Can you construct any relationship you choose between equity and loan capital?

The issue of fixed and variable capital forms for a corporation can be a sensitive one. Some companies have had difficulties in raising the investment limits of fixed capital subsidiaries. For example, rules about foreign ownership, or about administrative policies, may have changed between the years a subsidiary was formed and the time the United States parent decides to increase its equity contribution.

A general issue, not a technical one, revolves around a host country's securities regulation. Is the securities regulation dedicated merely to avoiding fraud, or does it cover full disclosure? Or is the securities regulation aimed at consumer protection with the requirement that a government agency approve the security as a good investment? Furthermore, what accounting standards are followed in the domestic securities regulation? Do they give rise to any serious problems when the United States parent wants to issue consolidated statements?

TAX STRUCTURE

The tax structure, of course, provides a key issue for the United States investor. Obviously, definitions of taxable income and tax rates are significant. Beyond this general condition, however, are questions relating to corporate form,

capital structure, and fee payments to the United States parents. In some countries the form of business organization will have an influence on the tax bills. An equity-debt combination for capital structure may raise issues about recognition of the debt as a loan rather than an equity investment. Interest may be treated as dividends. Interest may be imputed when the debt does not carry interest -- even if it is in the form of an account receivable for goods or services purchased. Even repayment of a debt may be treated as a dividend, subject to domestic taxes.

Significant problems may arise from arrangements for payments of patent royalties, of annual fees for technical aid, and of technical service fees on a project basis. Is the fee reasonable or should it be treated, in part, as a dividend? Should the tax withheld be calculated on a technical aid or a dividend basis? If a payment is treated as a dividend, did the subsidiary have sufficient capital left?

GOVERNMENT REGULATIONS

Not to be overlooked is the significant area of government regulation. The nature of these activities is so varied that one can do little more than mention the area. What are the permissible activities of companies with foreign shareholders? What is the nature of the regulation of health and safety standards; labeling; wages and fringe benefits, including profit sharing, and severance pay? Many other regulations may cover such items as plant location; proportion of foreign executives and technicians; conditions of production; credit terms; packaging; work permits; collective bargaining; allocation of production; and membership in trade associations.

In many countries government regulation may constitute an important element in determining the form of the venture and national participation. Though there may be no formal requirement of ownership by nationals, a wholly-owned United States subsidiary may find it impossible to obtain essential permits. Indeed, some companies have been compelled to cope with securities regulation in order to start operations. Thus, a large company may find it necessary to sell 51 per cent of the shares to nationals. To retain control it may sell shares as widely as possible. In some cases, it has agreed to sell 51 per cent when and as the securities market can absorb that much.

PATENTS AND TRADEMARKS

National regulation of patents and trademarks may affect the form of the venture. How strong is the patent right? Can the trademark be protected? Are patent licenses compulsory; if so, under what conditions? Can patent licenses be revoked?

UNITED STATES ANTI-TRUST REGULATION

Many of our own government regulations have a profound effect upon the nature and the type of operations in other countries. Subsidiaries abroad -- wholly-owned, partially-owned,

or joint-ventures -- frequently entail important antitrust aspects, elements which can be influenced profoundly by the basic structure of the foreign venture and its methods of operation. Some companies have had serious difficulties because they overlooked antitrust in setting up a subsidiary. When the antitrust danger has become evident, these companies have found it extremely difficult, almost impossible, to make the necessary rearrangements. These issues can arise long before any antitrust complaint is received. The mere inquiry from the Federal Trade Commission or the Antitrust Division of the Department of Justice is sufficient.

The problems inherent in adjusting existing arrangements can be serious. The United States company may have to pay a tremendous price to reform the arrangement, a price which could have been avoided if the antitrust situation had been analyzed before the venture was started.

EXCHANGE CONTROLS

Another type of United States regulation is the comparatively new control of foreign investment to support our balance of payments. These regulations affect new investments, as well as increases in existing ones. Indeed, as we shall see, these controls have been one of the principal elements which stimulated the recent United States interest in securities regulation abroad.

HOST COUNTRY'S DEVELOPMENT

The contours of each of the issues we have discussed will be influenced by the economic development of the host country. The problems found in an industrialized economy differ greatly from those of a lesser-developed nation. The size of the market will influence the scale of the venture. The degree of sophistication of government regulation and of the legal system affect the basic nature of the problem. Indeed, the existence of a securities market and mature private financial institutions may provide the essential basis for any concern about securities.

All of these elements will be affected by the process of economic integration. Ongoing integration will affect every issue we have discussed -- either under current conditions or in future developments. Thus the European Common Market will affect securities markets, government regulation, patents, availability of financial resources and partners in joint ventures, patents, regulation of restrictive business practices, and the size of the market. Development of a significant European company law would have a profound influence on each question we have discussed.

In sum, the consideration of foreign securities regulation must take place against the background of capital formation and business operations. These underlying conditions are prerequisites to the need even to consider securities regulation. At the same time, these underlying conditions provide both essential business needs which must be satisfied and constraints which are placed on capital formation abroad.

Finally, I cannot resist making a point which relates to this setting -- a conference organized by a law school and an active international law society. It seems to me that one of the most exciting developing areas of the law centers on international transactions. Many developments, here and abroad, point to growing international trade and investment. Expanding international aspects of business increase the opportunities for fascinating, imaginative careers for young lawyers and provide an important element of choice for today's law students.