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THE INTERNATIONAL LAWYER

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U.K. Regulatory Revision—A New Blueprint for Reform

G.A. Walker*

Abstract

A number of important regulatory reforms have been taken forward in the United Kingdom following the global financial crisis, which began with the tightening of credit conditions in interbank markets in autumn 2007 and the following devastating collapses in summer 2008 in the United States, United Kingdom, and elsewhere. A series of key initiatives were adopted by the outgoing Labour Administration in the United Kingdom before the General Election in May 2010. These have since been followed by more fundamental institutional reforms, and further proposed structural revision, by the new Coalition Conservative and Liberal Democrat Government that has since taken office. This includes amendment of the underlying statutory basis for U.K. financial regulation and replacement of the former single-integrated authority with a new central bank based macro-prudential and split-conduct-of-business model. A number of other important connected financial policies have also been continued, or newly created, over the last two years. All of this creates an important new blueprint for regulatory reform for possible consideration and adoption in other countries or other policy reform discussions.

Introduction

Her Majesty’s Treasury in the United Kingdom published the Draft Financial Services Bill on January 26, 2012, which will significantly restructure financial regulation for de-

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cades to come. This followed an earlier period of pre-legislative scrutiny between July and December 2011. The Bill provides for substantial institutional reform of the current single-integrated regulatory approach that was established under the Financial Services and Markets Act (FSMA) 2000.

Following the General Election in May 2010, the new Coalition Conservative and Liberal Democrat Government has confirmed that it will rebuild financial regulation around the Bank of England. The former Financial Services Authority (FSA) is to be abandoned and core prudential regulation is to be transferred to a new subsidiary of the Bank, the Prudential Regulatory Authority (PRA), with conduct of business and markets being transferred to a separate Financial Conduct Authority (FCA). A new Financial Policy Committee (FPC) will be set up within the Bank to carry out macro-prudential oversight of the U.K. financial system. The Bank of England will then become directly responsible for monetary policy, regulatory policy, and wider financial system oversight, as well as payments systems and financial infrastructure, under a new central bank based macro-prudential model.

The changes were originally announced by the Chancellor of the Exchequer at his Mansion House Address on June 16, 2010, with further details being provided in Parliament by the Financial Secretary Mark Hoban on June 17, 2010. Consultation documents were issued by the Treasury in July 2010 and February 2011 and then again in June 2011. These explained the basis for the changes and outlined the structure of the new institutional system to be created. The reforms have been examined by a Joint Parliamentary Select Committee on the Draft Bill Report, with the nature and function of the new institutional structure being considered by a separate Parliamentary Treasury Select Committee (TSC). Both Committees took evidence and held a number of hearings on the proposed reforms. The Joint Select Committee released its report on December 19, 2011, with the TSC having published an initial report at the end of January 2011 and further comment papers on other specific issues following.

The Chancellor of the Exchequer, under the Coalition Government, had established a separate Independent Commission on Banking (ICB) to make recommendations to strengthen the U.K. banking system and to promote competition following the financial crisis in the United Kingdom during 2008-2009. The ICB published an Interim Report


4. See Hon. George Osborne, Chancellor of the Exchequer, HM Treasury, Speech at The Lord Mayor’s Dinner for Bankers & Merchants at Mansion House (June 16, 2010).


on April 11, 2011 following an earlier issues paper.⁷ A final paper was released in September 2011.⁸ The ICB recommended the establishment of a structural “retail ring-fence” within the largest U.K. banking groups to insulate household and Small and Medium Enterprise (SME) account facilities from wholesale and investment banking and to impose higher capital and loss absorbing debt limits on the ring-fenced operations. The Government confirmed that it would implement the recommendations of the ICB in full during the current Parliamentary session.

The Coalition Government has also taken forward a number of other reform initiatives. These include converting the earlier Labour Government bank charge into a permanent “Bank Levy.” Earlier bank remuneration reforms are to be continued with a new Code of Conduct that has been incorporated into the FSA’s Handbook of Rules and Guidance issued under the FSMA.⁹ The Government has been pressing the major banks to lend to medium and smaller enterprises and households under “Project Merlin,” which finally came into operation in February 2011.¹⁰ This was then terminated in February 2012 and was to be replaced by a new Government “National Loan Guarantee Scheme” that was announced by the Chancellor in his Autumn Statement in November 2011.¹¹ The Labour Government had also set up the U.K. Financial Investments (UKFI) to hold the Government’s investments in major banks that received capital injections in 2008 and 2009, as well as a separate U.K. Asset Protection Agency (APA) to provide guarantees to major banks holding distressed (toxic) assets following the crisis. The Government had separately pressured the major banks to enter into a “Code of Practice on Taxation” on tax management and avoidance.

The new Coalition Government has accordingly continued or launched a number of important new initiatives in the financial and regulatory area. Many of these are claimed to be necessary following the financial crises that devastated national and international financial markets between 2007 and 2009, although much of it also reflects underlying political ideology and policy. A number of important reforms had already been instituted by the outgoing Labour Administration, which included introducing a new Special Resolution Regime (SRR) for banks and the establishment of a Financial Stability Committee (FSC) within the Bank of England under the Banking Act 2009 with the creation of a separate inter-agency Council for Financial Stability (CFS) to coordinate macro-prudential oversight in the United Kingdom.¹² The further post-election reforms announced continue a substantial part of the earlier regime and revisions, although within a more centralized and strengthened central bank based institutional model.

The purpose of this paper is to examine the nature and content of the Coalition Government’s recent reform program. The policy basis for the revisions is examined with

⁸. INDEP. COMM’N ON BANKING, FINAL REPORT, RECOMMENDATIONS (2011) (U.K.); INTERIM REPORT, supra note 7.
¹². See generally Walker, supra note 1 (discussing the earlier Labour Administration reforms).
reference to the earlier consultation documents in July 2010, February 2011, and June
2011. The structure and content of the Draft Financial Services Bill and emerging shape
of the new institutional regulatory structure in the United Kingdom are then examined in
further detail. Some of the early comments made by the Treasury Select Committee on
financial regulation are noted with the principal recommendations of the Joint Committee
Report on the Financial Services Bill. The proposed function and operations of the PRA
and FCA are reviewed separately. The principal reform suggestions of the ICB in its
Interim and Final Reports in April and September 2011 are referenced. The Govern-
ment’s other initiatives—with regard to remuneration, bank levy, bank lending, asset
holdings and guarantees, and taxation—are also reviewed. Provisional comments and
conclusions are drawn with regard to the significance, value, and effectiveness of the new
regulatory model being constructed in the United Kingdom at this time.

I. A New Approach to Financial Regulation and Building a Stronger System

The new regulatory regime to be set up in the United Kingdom was initially announced
by the Chancellor of the Exchequer during his Mansion House speech on June 16, 2010,
and the Treasury subsequently issued a formal consultation document titled A New Ap-
proach to Financial Regulation on July 2010.\textsuperscript{13} The paper outlined the causes of the finan-
cial crisis\textsuperscript{14} and argued for the need for reform over the earlier tripartite regulatory model
that had been set up under the integrated regulatory structure adopted by the outgoing
Labour Administration under the FSMA 2000. The paper stressed the need to establish a
new macro-prudential regulation regime and the need for the separation of prudential
from consumer protection and market regulation. The enhanced role of the Bank of En-
gland was outlined with the role and function of the proposed FPC, PRA, and a Con-
sumer Protection and Markets Authority (CPMA), which was subsequently renamed to
create the FCA.\textsuperscript{15} The paper also commented on markets and infrastructure, crisis man-
agement, and implementation.\textsuperscript{16}

The Government accepted the complexity of the changes proposed with further consul-
tation documents to be issued in February and June 2011, which included draft legislation
on the main parts of the proposed Reform Bill. Appropriate transitional arrangements
were to be adopted. These included reorganizing the FSA with a “shadow” internal struc-
ture being set up to allocate FSA staff and responsibilities between the PRA and FCA on a
provisional basis.\textsuperscript{17} An interim FPC would be set up within the Bank of England by au-
tumn 2010 to carry out preparatory work and to discharge a provisional macro-prudential
function. This would replace the earlier CFS. A number of principles were to guide the

\textsuperscript{13} JUDGEMENT, FOCUS AND STABILITY, supra note 5.

\textsuperscript{14} The fundamental causes of the crisis are summarized in terms of: (a) global economic imbalances; (b)
mispriced and misunderstood risks; (c) unsustainable funding and business models for banks; (d) excessive
build-up of debt across the financial system; and (e) growth of an unregulated “shadow banking” system. Id. ¶

\textsuperscript{15} Id. at 9-40.

\textsuperscript{16} Id. at 41-56.

\textsuperscript{17} The FSA would also prepare a new operating model, to be agreed upon before the end of 2010, dealing
with structure, resource, and risk-based supervision within the PRA and CPMA with the Bank being repre-
sented on the internal working committees. Id. ¶ 7.9.
transitional measures adopted.\textsuperscript{18} The July 2010 Green Paper set out the general outline of the new arrangements, although a number of more detailed matters would have to be confirmed over time.

The Coalition Government published a follow-up consultation paper in February 2011 titled \textit{A New Approach to Financial Regulation: Building a Stronger System}.\textsuperscript{19} The Treasury Select Committee had also published its report on U.K. financial reform, \textit{Financial Regulation: A Preliminary Consideration of the Government’s Proposals}, on February 3, 2011.\textsuperscript{20} The Treasury issued its views on the consultation responses received in November 2010, which were claimed to have generally supported the move to strengthen financial stability and macro-prudential regulation.\textsuperscript{21} The Government identified five key themes following the initial consultation process. The new regulatory authorities’ core statutory objectives had to be balanced and supplemented by other factors. The accountability and transparency had to be ensured of the PRA, the FCA, and the FPC. The FCA had to discharge a strong and coherent market regulation function that included acting as U.K. Listing Authority (UKLA). The authorities had to continue to contribute to the emerging European and international regulatory agenda during the transitional phase and final “steady” state. There had to be effective coordination between the new regulatory authorities.

Consultation on the February 2011 paper was limited to April 14, 2011, with this being justified by the Government in terms of the need to remain within its original legislative timetable. The Report nevertheless acknowledged the Treasury Select Committee’s concern that the quality of the legislation could be compromised if the Government pursued its timetable too rigidly.\textsuperscript{22} The Government published a White Paper in February 2011 with a draft Bill for pre-legislative scrutiny (PLS) and with a full twelve Parliamentary sitting weeks being provided for scrutiny until December 2011,\textsuperscript{23} which would involve convening a separate Joint Scrutiny Committee of the House of Commons and House of Lords to examine the Bill clause by clause. The Government published a further White Paper with accompanying Explanatory Notes in June 2011 with the Draft Financial Services Bill that would amend the FSMA.\textsuperscript{24} A number of further consultation questions were raised with the Treasury also commenting on the responses received to the earlier consultation.\textsuperscript{25} It was intended that the final draft Bill would be introduced in summer 2011 and receive Royal Assent in summer 2012, although these dates would later have to be pushed back to spring 2012 and 2013, respectively.

\textsuperscript{18} These included: (a) maintaining high quality, focused regulation; (b) minimizing uncertainty and transitional costs for firms; (c) balancing implementation with appropriate scrutiny and consultation; and (d) providing as much clarity and certainty as possible for FSA, Bank, and other staff. \textit{Id.} ¶ 7.5.

\textsuperscript{19} \textit{Building a Stronger System}, supra note 5.

\textsuperscript{20} \textit{A Preliminary Consideration}, supra note 6.


\textsuperscript{22} \textit{Id.} ¶ 8.3.

\textsuperscript{23} \textit{Id.} ¶¶ 8.5-.6.

\textsuperscript{24} \textit{Blueprint for Reform}, supra note 3, at 31-365.

\textsuperscript{25} \textit{Id.} at 367-408.
II. Financial Services Bill

The Draft Financial Services Bill was presented to House of Commons on January 26, 2012. The Bill sets out the new framework for financial regulation in the United Kingdom with responsibility for financial stability being placed with the Bank of England. This was provided for in the Coalition Government’s program statement. The Bill sets out the powers, objectives, and principles for each of the new agencies established, including, in particular, the FPC, PRA, and FCA. This involves the transfer of the existing powers from the FSA to the PRA and the FCA, with certain new powers also being provided. Provisions are included to secure accountability of the regulatory agencies with specific provisions on the constitution of their governing bodies. Cooperation is to be secured through the imposition of a statutory duty to coordinate with each other and cooperate with the Bank with further provisions governing the coordination of memberships of European and international bodies. Specific mechanisms are included governing the responsibilities between the Treasury, Bank, PRA, and FCA in the event of a financial crisis.

The Bill is in nine parts and makes amendments to the Bank of England Act 1998 and FSMA 2000. It contains provisions on mutual societies and collaboration between agencies; further measures on inquiries and investigations, complaints against the regulators, and amendments to the Banking Act 2009; and certain other miscellaneous and general matters. The Bill extends to the whole of the United Kingdom and covers matters relating to U.K. financial services and markets with no powers having been delegated to the National Assembly for Wales or Scottish Parliament.

A. Financial Stability Objective and Strategy

A new Deputy Governor of the Bank of England is to be appointed for prudential regulation in addition to the existing Deputy Governors for financial stability and monetary policy. The “Financial Stability Objective” of the Bank is strengthened by amending the language from requiring the Bank to “contribute to protecting and enhancing” to “protect and enhance” financial stability and replacing the earlier reference to “financial systems” by “financial system.” The Court of Directors of the Bank is required to prepare the Bank’s “Financial Stability Strategy” following consultation with the FPC and Treasury. The strategy is to be prepared within six months and reviewed every three years subject to FPC recommendations.
The Bill provides for the establishment of the FPC with twelve members consisting of the Governor, Deputy Governors, Chief Executive of the FCA, two members appointed by the Governor, four members appointed by the Chancellor, and a Treasury representative. The FPC is to contribute to the Bank’s achievement of its Finance Stability Objective, in particular, by identifying, monitoring, and taking action to remove or reduce systemic risks to protect and enhance the resilience of the U.K. financial system. A systemic risk is any risk to the stability of the U.K. financial system as a whole or as a significant part. The Treasury may make recommendations to the FPC at any time in writing. Recommendations must be within the first thirty days of the section coming into force and annually. The FPC must confirm whether it accepts the recommendations and the action taken in response.

The functions of the FPC are to monitor the stability of the U.K. financial system, issue directions, make recommendations, and prepare financial stability reports. In carrying out its functions, it is to have regard to the Bank’s financial stability strategy and avoid prejudicing the PRA or FCA securing their objectives. The FPC may issue directions to the FCA or PRA on macro-prudential measures or recommendations within the Bank, to the Treasury or FCA and PRA or other persons. The Bank is to publish a record of each meeting of the FPC within six weeks except where this may not be in the public interest. The FPC is to publish biannual Financial Stability Reports. The Governor and Chancellor are to meet following each report with a record of the meeting to be published within six weeks. The Bank may issue a direction to the FCA and PRA requiring specified information (or information of a specified description) or the production of specified documents (or documents of a specified description). The information or documents must reasonably be required in connection with the exercise of its functions with regard to

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33. Id. pt. 1, cl. 3(1)(9B).
34. Id. pt. 1, cl. 3(1)(9C).
35. “This includes risks attributable to structural features of financial markets [or] the distribution of risk within the financial sector and unsustainable levels of leverage, debt or credit growth.” Id. pt. 1, cl. 3(1)(9C)(3), (5).
36. The recommendations may relate to the FPC’s understanding of the Financial Stability Objective, its responsibility with regard to the objective or any other matters that the FPC “should have regard in exercising its functions.” Id. pt. 1, cl. 3(1)(9D).
37. Id. pt. 1, cl. 3(1)(9D)(2).
38. Id. pt. 1, cl. 3(1)(9D)(3).
39. The FPC may give directions to the FCA and PRA on macro-prudential measures in relation to a specified class of regulated persons. Id. pt. 1, cl. 3(1)(9G)(1). The FCA and PRA must comply with the direction give subject to revocation. Id. pt. 1, cl. 3(1)(9H)-9I. Macro-prudential measures are to be prescribed by the Treasury by order subject to Parliamentary approval by resolution. Id. pt. 1, cl. 3(1)(9M).
40. The FPC may make recommendations within the Bank concerning financial assistance to financial institutions or with regard to “payment systems, settlement systems and clearing houses.” Id. pt. 1, cl. 3(1)(9N). Recommendations may be made to the Treasury in connection with macro-prudential measures, regulated activities, activities subject to regulation by the PRA or FAC, or persons required to provide information by the PRA. Id. pt. 1, cl. 3(1)(9Q). “The Financial Policy Committee may make recommendations to the FCA and PRA about the exercise of their respective functions,” except in connection with specified regulated persons. Id. pt. 1, cl. 3(1)(9P). The FPC has a general power to make recommendations to any other persons subject to being made or confirmed in writing. Id. pt. 1, cl. 3(1)(9R).
41. Id. pt. 1, cl. 3(1)(9R).
42. Id. pt. 1, cl. 3(1)(9T).
43. Id. pt. 1, cl. 3(1)(9U).
44. Id. pt. 1, cl. 3(1)(9V)(2).
the Financial Stability Objective, including functions under the Banking Act 2009, systemically important market infrastructure, and liquidity support. The Bank must consult with the FCA and PRA in advance and have regard to the principle of proportionality.45

Certain other general duties are imposed on the PRA. The FPC is to have regard to the Bank’s Financial Stability Strategy in the exercise of its functions.46 In working with the FCA and the PRA, the FPC is to seek to avoid exercising its functions in a way that would prejudice the advancement of the operational objectives for the PRA.47 The FPC is also to have regard to the principles of proportionality, disclosure of its views on relevant threats, and international obligations.48 This reflects some of the general supervisory principles that were retained from the FSMA and applied to the FCA and PRA with amendment.

B. FSMA

The Bill makes a number of amendments to the FSMA in connection with regulatory authorities, regulated activities, permission requirements, passports, performance, official listing, business transfers, hearings and appeals, rules and guidance, control, recognized investment exchanges and clearing houses, suspension from trading, discipline and enforcement, compensation, Ombudsman, Lloyd’s, information, auditors and actuaries, consumer protection and competition, insolvency, and other miscellaneous matters, including the Consumer Financial Education Body (CFEB), professional parties, international obligations, interpretation, and Parliamentary control of secondary legislation in the form of statutory instruments.49

1. Financial Conduct Authority (FCA)

The FSMA is amended to rename the FSA the FCA.50 A series of new provisions have been inserted into the FSMA concerning the FCA’s general duties, objectives, power to amend objectives and guidance on objectives, supervision, monitoring and enforcement, consultation, and reviews. The general duties of the FCA are defined in terms of securing its objectives and carrying out its general functions.51 In discharging its general functions, the FCA is to act, insofar as possible, in a way that is compatible with its strategic objective and advances one or more of its operational objectives. The FCA is assigned a separate strategic objective of ensuring that relevant markets function well,52 with three further operational objectives of consumer protection, integrity, and competition.53 The FCA is

45. Id. pt. 1, cl. 3(1)(9W)(1).
46. Id. pt. 1, cl. 3(1)(9E)(1).
47. Id. pt. 1, cl. 3(1)(9E)(2).
48. Id. pt. 1, cl. 3(1)(9E)(3).
49. Id. pt. 2.
50. Id. pt. 2, cl. 5.
51. Id. pt. 2, cl. 5(1)(1B)(1).
52. This was previously protecting and enhancing confidence in the U.K. financial system under the June 2011 Draft Bill.
53. Id. pt. 2, cl. 5(1)(1B)(2)-(3). “The consumer protection objective is: securing an appropriate degree of protection for consumers.” Id. pt. 2, cl. 5(1)(1C)(1). So doing, the FCA must have regard to differing degrees of investment and transaction risk, consumer experience, needs, individual responsibility, appropriateness, and any CFEB and Ombudsman information disclosure. Id. pt. 2, cl. 5(1)(1C)(2). “The integrity objective is:
also to have regard to specified regulatory principles and the importance of limiting financial crime. The general functions of the FCA are defined in terms of making rules, preparing and issuing codes, providing general guidance, and determining general policy principles.

The FCA is to maintain arrangements for supervising authorized persons, to determine compliance, and to take appropriate enforcement action. The FCA is required to make and maintain effective arrangements for consulting with practitioners and consumers. The earlier Practitioner Panel and Smaller Business Practitioner Panel set up under FSMA are given statutory recognition. A new Markets Practitioner Panel to represent the interests of firms and persons affected by the FCA’s functions is also to be set up, in addition to the existing Consumer Panel. The FCA must consider the representations made by the panels. The Treasury may appoint an independent review of the economy, efficiency, and effectiveness of the way in which the FCA has used its resources with the person appointed having the right to obtain all necessary documents and information.

The constitutional provisions that earlier governed the FSA under Schedule 1 FSMA are amended to apply to the FCA and PRA.
2. **Prudential Regulatory Authority (PRA)**

The PRA is set up separately under the revised FSMA. The Bill includes provisions with regard to the general duties of the PRA, the imposition of a specific insurance objective, additional objectives, interpretation and guidance of objectives, supervision, consultation, and Treasury review of the PRA activities. The PRA is to act, in so far as reasonably possible, in a way that advances its general objective. The general objective of the PRA is to promote the safety and soundness of PRA-authorized persons, which involves ensuring that the business of such persons is carried out in a way that avoids any adverse effect on the stability of the U.K. financial system while seeking to ensure that any adverse effect of the failure of such a person is minimized. The PRA is also to act in a way that is compatible with both its general objective and insurance objective, which is contributing to the securing of an appropriate degree of protection for those who are or may become policyholders. Further objectives may be specified where the list of PRA-regulated activities is extended by order. The PRA is expressly not required to ensure that no PRA-authorized person fails. The PRA is to have regard to the same regulatory principles as the FCA in discharging its general functions. The PRA is required to consult with PRA-authorized persons, or persons representing their interests, with appropriate panels being set up as necessary. The PRA is required to consider any representations made and publish its responses to such representations from time to time. The Treasury is given equivalent power to appoint an independent review of the economy, efficiency, and effectiveness with which the PRA uses its resources in discharging its functions.

3. **Common Provisions**

The FCA and PRA are collectively referred to as the “regulators.” Relevant constitutional investigation of complaints, status, penalties and fees, and other miscellaneous provisions (including immunity from liability in damages) are applied by way of amendment to Schedule 1 of the FSMA. Similar regulatory principles to those applicable to the FSA

62. Id. pt. 2, ch. 2, cl. (2A)(1). The Prudential Regulation Authority Limited, which was set up before the Bill, is renamed the Prudential Regulation Authority (PRA) for the purposes of the Bill. Id.
63. Id. pt. 2, ch. 2, cl. (2B)(3). The adverse effects referred to may result from the disruption of the continuity of financial services. Id. pt. 2, ch. 2, cl. (2B)(4). The U.K. financial system includes financial markets and exchanges, regulated activities, and other activities connected with financial markets and exchanges. Id. pt. 2, cl. 5(1)(II). Failure includes insolvency, stabilization (under Part 1 of Banking Act 2009), or the authorized person is considered to be unable, or likely to be unable, to satisfy claims against it under the Financial Services Compensation Scheme. Insolvency includes bankruptcy, liquidation, bank insolvency, administration, bank administration, receivership, composition, or a scheme of arrangement. Id. pt. 2, ch. 2, cl. (2B).
64. Id. pt. 2, ch. 2, cl. (2C).
65. Id. pt. 2, ch. 2, cl. (2D).
66. Id. pt. 2, ch. 2, cl. (2E).
67. Id. pt. 2, ch. 2, cl. (2F).
68. Id. pt. 2, ch. 2, cl. (2G).
69. Id. pt. 2, ch. 2, cl. (2H).
70. Id. pt. 2, ch. 2, cls. (2K)-(2L).
71. Id. pt. 2, ch. 2, cls. (2M)-(2N).
72. Id. pt. 2, ch. 3, cl. (3A)(2).
73. Schedules 1ZA and 1ZB FSMA inserted under Schedule 3 Bill. See supra note 61.
are restated with some amendment for the FCA and PRA. Both authorities are required, as with the FSA, to have regard for such generally accepted principles of good governance as are reasonably applicable.\textsuperscript{74} New requirements are inserted governing the relationship between the FCA and PRA. The regulators are required to coordinate the exercise of their respective qualifying functions, including consulting and exchanging relevant information and to use their resources efficiently, economically, and proportionately.\textsuperscript{75} The FCA is responsible for ensuring that with-profit insurance policyholders receive an appropriate degree of protection.\textsuperscript{76} The regulators are to enter into an MOU specifying their respective roles and how they will comply with the duty to coordinate imposed regulations.\textsuperscript{77} A draft MOU between the FCA and PRA was produced by the Bank of England and FSA in 2012.\textsuperscript{78}

The Treasury may by orders allocate responsibilities between the regulators, including specifying primary or sole functions, subject to Parliamentary approval.\textsuperscript{79} The PRA is given express power to direct the FCA not to take any regulatory action against a particular PRA-authorized person, or class of persons, in the exercise of the FCA’s regulatory or insolvency powers.\textsuperscript{80} The PRA must consider that the exercise may threaten the stability of the U.K. financial system or result in the failure of the person concerned, which would affect the system, and that the direction is necessary for either of these purposes.\textsuperscript{81} The PRA must consult the FCA in advance and provide the Treasury with a copy of the direction, which must be submitted to Parliament.\textsuperscript{82} Either regulator may issue directions to the other in connection with the consolidated supervision of some or all of the members of a group under relevant E.U. directives where one acts as the competent authority for the group.\textsuperscript{83} The direction may require the other regulator to exercise, or not exercise, a relevant function.\textsuperscript{84} Both regulators are subject to a general duty to take such steps as are considered appropriate to coordinate with the Bank in connection with its Financial Stability Objective and have a duty to notify the Treasury of the possible need for public

\begin{footnotesize}

\textsuperscript{74} Id. pt. 2, ch. 3, cl. (3C).

\textsuperscript{75} Id. pt. 2, ch. 3, cl. (3D)(1).

\textsuperscript{76} Id. pt. 2, ch. 3, cl. (3F).

\textsuperscript{77} See id. pt. 2, ch. 3, cl. (3E)(1). Specified further provisions may be included in the MOU dealing with such matters as Part 4A permission applications, variation, requirements, disclosure, group applications, EEA passport and treaty rights, information gathering, and investigations, control, incoming firms, Lloyd’s of London, records, and fees. Id. pt. 2, ch. 3, cl. (3E)(2). The MOU must contain provisions governing the coordination of relations with other non-U.K. bodies, E.U. authorities, and compensation scheme function. Id. pt. 2, ch. 3, cl. (3E)(3). The MOU must be reviewed annually with a revised copy being provided to the Treasury that must be laid before Parliament. Id. pt. 2, ch. 3, cl. (3E)(4), (6).


\textsuperscript{79} Financial Services Bill, pt. 2, ch. 3, cls. (3G)-(3H) (U.K.).

\textsuperscript{80} Id. pt. 2, ch. 3, cl. (3I).

\textsuperscript{81} See id. pt. 2, ch. 3, cl. (3J)(2), (4)-(5). The PRA may revoke the direction at any time. Id. pt. 2, ch. 3, cl. (3J).

\textsuperscript{82} Id. pt. 2, ch. 3, cl. (3K)(1), (4)-(5).

\textsuperscript{83} Id. pt. 2, ch. 3, cl. (3L)(4).

\textsuperscript{84} Id. pt. 2, ch. 3, cl. (3L)(5). Revocation is dealt with under section 3M with procedural provisions in section 3N.

\end{footnotesize}
funds, including the sharing of permitted relevant information. The regulators may enter into arrangements for the provision of services between themselves.

III. Treasury Committee Report on Financial Regulation

The Treasury Select Committee within the House of Commons published an initial report on the Government’s proposed revision of U.K. financial regulation at the end of January 2011. This followed the Government’s original consultation paper titled A New Approach to Financial Regulation: Judgement, Focus and Stability, published in July 2010, and anticipated the later follow-up document published in February 2011 and titled A New Approach to Financial Regulation: Building a Stronger System. The Treasury Committee examined a number of provisional issues related to the proposed regulatory changes announced. These were principally concerned with the ambitious nature of the Government’s timetable, references to the Bank of England as a “super regulator,” the role and function of the PRA and FCA as well as regulatory cost, international regulatory integration, crisis management, transparency, and accountability. Each of these issues was considered in separate chapters within the February 2011 Report.

The Report noted the importance of the financial services industry within the U.K. economy and the need for it to be regulated in an effective but proportionate manner. The Committee was concerned that unnecessary urgency could be counter-productive, both in terms of financial stability and of certainty. The Committee accepted the advantage of insulating economic policy from short-term political decision-making, although difficulties remained in defining and managing financial stability and the new macro-prudential policy. The Government had to confirm the nature of possible tools through the publication of draft secondary legislation in early course.

The Treasury Committee accepted that the purpose of regulatory reform was to reduce the possibility of systemic risk without undermining the economic contribution of financial services. The financial services industry contributed around 10 percent of U.K. GDP in 2009 and was still the largest corporation taxpayer in 2010, responsible for 11.2 percent of total tax receipts. The financial crisis nevertheless cost the U.K. Government £74 billion.

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85. See id. pt. 2, ch. 3, cl. (3P); pt. 4, cls. 54-55.
86. Id. pt. 2, ch. 3, cl. (3Q)(1).
87. A Preliminary Consideration of the Gov’t’s Proposals, supra note 6, at 27.
88. See Judgement, Focus and Stability, supra note 5; Building a Stronger System, supra note 5.
89. A Preliminary Consideration of the Gov’t’s Proposals, supra note 6, at 3.
90. Duncan McKenzie, Financial Markets in the UK, TheCityUK, Nov. 2010, at 3, http://www.thecityuk.com/assets/Uploads/IFM201011.pdf; see also PricewaterhouseCoopers, The Total Tax Contribution of UK Financial Services (3d ed. 2010), at 3, available at http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2010/Total%20Tax%20Contribution%20of%20the%20Financial%20Services_ThirdEdition.pdf. The Financial Services Sector Employed 993,000 people by sector end June 2012. McKenzie, supra, at 3. Banking made up 4.7 percent of GDP; insurance, 2 percent; fund management, 0.67 percent; and securities, derivatives, commodities, and bullion the remaining 2.63 percent. Id. at 6, 7, 10. The London Equity market was the second largest in the world with eleven percent of global market share in 2009. A Preliminary Consideration of the Gov’t’s Proposals, supra note 6, at 8. The insurance industry was the largest in Europe and third largest in the world with premiums in 2009 of £200 billion of premiums alone in 2009. Id. Lloyd’s of London generated £22 billion of premia alone in 2009. Id. at 11. The U.K. fund management industry was the largest in the world with £4.1 trillion of assets under management in 2009. Id. at 8.
percent of GDP and the U.S. Government 73 percent of GDP. Total global output in 2009 was around 6.5 percent lower than expected following the crisis.

The Committee considered that the FPC should have a strong non-Bank representative element with separate accountability regimes having to be set up in respect of the FPC and the Bank’s MPC. The regulatory approach to be adopted by the PRA, in respect of systemically important institutions, had to be confirmed with the description of the FCA as being a “consumer champion” being “inappropriate, confusing and potentially dangerous.” The Committee supported the competition objective of the FCA although the overall cost of regulation had to be confirmed further as ultimately all direct and indirect costs would be passed back to the consumer. Uncertainties also remained with regard to the regulation of certain sectors and the division of responsibility between the PRA and the FCA, such as with regard to fund management and more complex groups.

IV. Joint Committee Report

The Joint Parliamentary Committee published its First Report on the Draft Financial Services Bill in December 2011. The Joint Committee Report contained a number of recommendations to ensure that the new regulatory regime set up under the Bill secured its intended objective of preventing any future calamitous systemic failure of the U.K. financial sector. The recommendations were specifically intended to ensure that the new

94. A PRELIMINARY CONSIDERATION OF THE GOV’T’S PROPOSALS, supra note 6, at 4.
95. JOINT COMMITTEE ON THE DRAFT FINANCIAL SERVICES BILL, DRAFT FINANCIAL SERVICES BILL, 2010-12, H.L. 256, H.C. 1447 (U.K.).
authorities had the correct objectives, powers, and responsibilities and that appropriate systems of accountability were in place. The Joint Committee specifically considered the objectives of the FPC, the PRA, and the FCA; their responsibilities and powers; and the need to establish an appropriate accountability, transparency, and enforcement regime.96

The Joint Committee accepted that no regulatory structure could prevent any future banking failures or crises, irrespective of how well it was designed, with legislation having to make proper provision for handling crises and resolving bank failures. The crisis had significant economic, social, and political impact within the United Kingdom and highlighted weaknesses in the earlier tripartite regulatory structure, FSA supervision and crisis management arrangements, and resolution procedures. It was considered that successful regulation was dependent more on the regulatory culture, focus, and philosophy than structure in ensuring the effective handling of risk. The assumption of rational perfect markets was questioned and the earlier U.K. regulatory structure criticized for not having its focus on financial stability. The Joint Committee recommended the adoption of a key “cultural change” towards the adoption of a more “forward looking supervision” approach, with regulatory staff having appropriate experience, approach, and attitude.

The Joint Committee Report was more concerned with culture from a regulatory, rather than internal firm, perspective, although it did stress the need for effective risk management overall. The Report made repeated reference to the ICB recommendations on ring-fencing and higher capital requirements.97 The Joint Committee strongly supported the ICB proposals and recommended that the legislation be brought forward during the 2012-2013 Parliamentary Session to provide banks with a clear framework for implementing the recommendations as quickly as possible.

The Joint Committee recommended that the Treasury and Parliament be given more oversight powers over the macro-prudential activities of the FPC. The recommendations included replacing the Bank of England’s Court of Directors with a “Supervisory Board” that would include some members with direct experience of operating in the financial services industry. The Supervisory Board should have specific responsibility to review the performance of the FPC and to be consulted on the appointment of any new Governor to the Bank. The FPC should be treated on an equal basis with the Bank’s existing Monetary Policy Committee (MPC) with FPC membership being extended to include insurance and wider economic interest. External members should have a majority voting position as against internal Bank staff with reports on major regulatory failure being prepared on a regular basis. The objectives of the PRA and FSA should be clarified. A number of specific recommendations were made to extend the powers of the PRA and FCA.

V. Prudential Regulation Authority

The Bank of England and the FSA issued a joint paper in May 2011 on the supervisory approach to be adopted by the Prudential Regulatory Authority (PRA).98 A separate paper on the supervision of insurance companies was to be released in May 2011, although this

96. Id. at 7, 13, 22, 26-27.
97. See infra Part VII.
was delayed until June 2011 with a separate paper on the FCA. Both documents were updated in 2012.99 The Bank and FSA had arranged a launch Conference for the PRA on May 19, 2011.

The role of the PRA would undertake the key regulatory functions within the new regime as it would principally be responsible for supervising firms holding at least £9 trillion in assets, which was seven times the U.K. GDP with U.K. banks alone holding five times the U.K. GDP.100 The PRA would regulate 157 U.K.-incorporated banks, 48 building societies, 652 credit unions, and 162 branches of overseas banks from the European Economic Area (EEA) and globally.101 Around 2,000 firms would be subject to PRA oversight.102

The PRA supervisory paper deals with underlying supervisory principles, scope, risk assessment framework, supervision, policymaking and firm authorization, and individual approval. The new approach was being developed by the Prudential Business Unit, which was set up within the FSA on April 4, 2011, in cooperation with the Bank of England.103

A. PRA Principles

The single objective of the PRA would be to promote the safety and soundness of regulated firms and, in so doing, to minimize any adverse effects of firm failure on the U.K. financial system. The PRA would not be required to ensure that no authorized firm fails, which would remain the responsibility of firm management, board, and shareholders.104 PRA supervision would be targeted at firms’ resilience (capital, liquidity, and leverage), interventions, and resolution.105 All firms would be subject to a baseline level of supervisory oversight, which would reduce the probability of failure or that a firm failed in an orderly manner.106 The PRA would work closely with the Financial Policy Committee (FPC) within the Bank to combine individual and larger system’s oversight.107 Supervi-


100. OUR APPROACH TO INSURANCE SUPERVISION, supra note 98, at 7.

101. Id.

102. Id.


104. OUR APPROACH TO INSURANCE SUPERVISION, supra note 98, ¶ 1.

105. Id. ¶ 4.

106. Id. ¶ 6.

107. Id. ¶ 7.
sion would be risk based, targeted at the principal risks, be forward-looking, and require corrective action at an early stage to reduce the probability of disorderly failure.  

Supervisory staff would be required to form judgments on current and future risks to a firm’s safety and soundness, with major judgments requiring the involvement of senior and experienced individuals. The process was referred to as “rigorous and well-documented.” Arrangements would be adopted to ensure cooperation between the PRA, the FCA, the FPC, the Financial Services Compensation Scheme (FSCS), the Special Resolution Unit (SRU), and other parts of the Bank involved with macro-prudential analysis, market intelligence, and infrastructure oversight. The new policy would attempt to learn from the lessons of previous regulatory failures, as well as be properly coordinated with international and E.U. regulatory developments and ensure proper public accountability.

B. PRA Scope

The PRA would be responsible for the regulation of firms holding £9 trillion in assets and EEA firms with £2 trillion in assets. The U.K. market was nevertheless highly concentrated with “[85] percent of personal current accounts being provided by the five largest firms.” Financial services contributed 10 percent of U.K. GDP and banking contributed 5 percent of U.K. GDP. The PRA would also be responsible for the supervision of other firms that could present a significant risk to the stability of the financial system or to one or more PRA supervised entities within the same group. It was expected that this would include investment firms authorized to deal in investments as principal on their own account subject to additional designation criteria having regard to the size of the firm, substitutability of services, complexity, and interconnectedness. Other shadow banking activities may also be brought within the scope of supervision with the FPC monitoring the new “regulatory perimeter.”

C. PRA Risk Assessment Framework

The PRA would focus its resources on firms that generated the greatest risk to the stability of the U.K. financial system. A provisional risk assessment framework had been produced based on “gross risk” and “safety and soundness” with an assessment of potential impact and “risk context” (external and business risks) with regard to gross risk and risk mitigation factors in connection with safety and soundness, including operational (risk management and controls and management and governance), financial (liquidity and capital), and structural mitigation (resolvability). This would assess the impact of firm

108. Id. ¶ 12.
109. Id. ¶ 15.
110. Id. ¶ 16.
111. Id. ¶¶ 17-18.
112. Id. ¶ 22.
113. Id. ¶ 23.
114. Id. ¶ 24.
115. Id. ¶ 25.
116. Id. ¶ 26.
117. Financial Conduct Authority: Approach to Regulation, supra note 99, Fig. 1.
failure on the stability of the system and on whether orderly resolution was feasible and credible. The channels through which a firm might affect the stability of the system would be assessed having regard to impairment of the system to carry out its functions. The PRA would take into account loss of access to payment services.

In considering risk context, the PRA would assess how the external macroeconomic and business context may affect the execution of a firm’s business model under different scenarios. The PRA would then assess factors that may mitigate the adverse impact of a firm on the stability of the system including resolvability, financial strength (liquidity and capital), and risk management and governance.

D. PRA Supervision

The PRA’s approach to supervisory assessment was again described as being based on “forward-looking [judgments]” with “supervisory interventions” being clearly directed at reducing any major risk to the stability of the system. All firms would be subject to a baseline level of supervisory reporting with the PRA’s approach being more intensive where firms posed a greater risk to the system. Supervisory assessment would be focused on business risks, financial strength, risk management and governance, and resolvability. The PRA would work closely with auditors and internal finance, risk and compliance functions within firms, and use available external data. The PRA would identify where further corrective action was required by firms and use its statutory powers to secure necessary and remedial action on an ex ante basis.

The PRA would create a new “Proactive Intervention Framework” (PIF) to support the early identification of risks and actions in preparation for failure or resolution. This would be based on five stages of low risk to the viability of the firm, with no additional supervisory action being required; moderate, material, and imminent risks to the viability of the firm (Stages 2, 3, and 4), with specified recovery and resolution actions; and final resolution and winding-up (Stage 5). All firms would be placed within the PIF as appropriate although necessary adjustments would have to be made for dealing with EEA firms due to the limited powers available to the PRA under E.U. law.

E. PRA Policy

Prudential policies were stated to set out the high-level framework and expectations against which firms were to be assessed with prudential rules establishing minimum stan-
dards and prudential policy supporting judgment-based supervision.129 Policies and rules should be clear, intent, robust, and support timely intervention130 with firms being required to comply with “the spirit as well as the letter of its rules.”131 The PRA would continue to use cost and benefit analysis132 and be responsible for ensuring that remuneration policies and practices were properly risk aligned.133

F. PRA Authorization and Approval

The PRA would deal with applications for authorization134 with an assessment of resolvability being “embedded into the [authorization] process.”135 Authorization would be determined on a “whole firm” basis,136 with the FCA having to consent on the grant of relevant permission.137 The PRA would determine the approval of individuals carrying on significant influence functions in cooperation with the FCA. It was expected that this would include around 5,000 individuals within the 2,000 firms regulated by the PRA covering approximately 12,500 roles.138

VI. Financial Conduct Authority

The strategic objective of the FCA was stated in the earlier consultation documents to be to “protect and enhance confidence in the [U.K.] financial system” with three operational objectives of “securing an appropriate degree of protection for consumers,” promoting “efficiency and choice in the market for financial services,” and “protecting and enhancing” financial system integrity.139 This was later amended in the January 2012 Bill with the FCA’s strategic objective being to “[ensure] that the relevant markets function well” and with the three further operational objectives of consumer protection, integrity, and competition.140

The FSA held an FCA launch Conference in London in June 2011 to discuss the FCA’s new regulatory approach and operating model.141 The FCA’s new regulatory approach can be summarized in terms of “preventative action,” tackling problems rather than symptoms, differentiation, securing fair and safe markets, “engaging with retail consumers,” “credible deterrence” in addition to proper transparency and disclosure as well as account-

129. Id. ¶ 91.
130. Id. ¶ 92.
131. Id. ¶ 93.
132. Id. ¶ 105.
133. Id. ¶ 107.
134. Id. ¶ 110.
135. Id. ¶ 113.
136. Id. ¶ 112.
137. Id. ¶ 114.
138. Id. ¶ 118.
140. Securing Stability, Protecting Consumers, supra note 2, at 28.
The FCA will have new powers of product intervention, although the FSA has already issued substantial new guidelines in this regard. The FCA will be able to withdraw or amend misleading financial promotions and publish information on relevant issues using warning notices, although these are connected with technical powers rather than any new regulatory approach. The FCA will be expected to make more “[judgmental] trade-offs” between different, desirable objectives. The FCA will attempt to develop a new regulatory culture and “aspire to command the respect of consumers and of the firms it regulates.” It will have a new organizational culture and behavior that “reflects, and is best equipped to deliver, its new role and wide-ranging responsibilities” with a culture based on “[judgment] and sound analysis.” It will also be transparent and cooperative, as well as clear and succinct, taking prompt action to achieve its goals. Its decision-making process will, in particular, consist of a “senior level, high quality, business and market analysis team” that will provide the analysis required “to understand how markets work and how they interact with consumer [behavior].” This is already reflected in the FSA’s new post-crisis supervisory response, especially in such areas as product regulation.

It was also announced in January 2012, at the time of the release of the full Draft Financial Services Bill, that the FCA would become responsible for consumer credit regulation under the Consumer Credit Act 1974. These functions were previously carried out by the Office of Fair Trading (OFT) in the United Kingdom. The Government had released an earlier consultation document on the transfer of these functions in December 2010.

VII. Independent Commission on Banking

The Independent Commission on Banking (ICB) produced its interim report on April 11, 2011. This contained a number of provisional recommendations to strengthen the U.K. banking system and to promote competition at the same time as avoid the costs of any future bailout being born by the public through the Treasury. The ICB was originally set up by the Chancellor of the Exchequer on June 16, 2010 and was to report to the

142. Financial Conduct Authority: Approach to Regulation, supra note 99, ¶¶ 4.3, 4.6, 4.8-4.10, 4.13, 4.16-4.17.
143. Id. ¶ 1.9.
144. Id. ¶ 1.5.
145. Id. ¶ 1.15.
146. Id.
147. Id.
148. Id. ¶ 1.19.
151. Interim Report, supra note 7.
152. Id.
Cabinet Committee on Banking Reform by the end of September 2011. The ICB was chaired by Sir John Vickers with Clare Spotswood, Martin Taylor, Bill Winters, and Martin Wolf. The Commission held around nine meetings between July 2010 and April 2011 with separate public events in Cardiff and London.

The Commission published an initial Issues Paper in September 2010 as a call for evidence that contained a number of possible options for reform. The Issues Paper examined the U.K. banking sector (Chapter 2, “Where we are now”), relevant issues (Chapter 3, “Issues”), and options for reform (Chapter 4). The issues identified by the Commission included financial stability, competition, interaction of financial stability and competition, lending and the pace of economic recovery, the competitiveness of U.K. financial services and the wider economy, and the risk to the Government’s fiscal position. Separate structural and non-structural reform options were identified with regard to banks and markets.

The objective of the Interim Report was to set out the Commission’s initial and provisional views on stability and competition reform. The Report was generally based on the premise that improved stability requires that banks can absorb losses without reliance on the taxpayer and that businesses can fail safely without undue damage to the rest of the financial system and wider economy. This has partly been dealt with by separate initiatives to improve capital and liquidity, recovery and resolution, and market infrastructure, although the Commission attempted specifically to consider whether structural separation—in particular, between retail and investment banking—would promote stability. The ICB rejected more draconian structural options, including separating commercial and investment banking outright or adopting a full “subsidiarisation” model that would separate these activities across different companies within larger groups. A more limited form of partial subsidiarisation was recommended with the insulation of retail operations to protect depositors and the provision of critical functions. An equity Tier 1 capital ratio of at least 10 percent would be imposed on the retail activities of systemically important lenders with a 7 percent ratio for wholesale and investment banking. This would be supplemented by additional convertible debt.

The ICB released its Final Report on September 12, 2011, which set out its full recommendations following the further consultation responses received to its Interim Report in April 2011. The ICB had received 170 responses with a substantial amount of further

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155. Call for Evidence, supra note 7.
156. Id. at 9.
157. Id. at 17.
158. Id. at 31.
159. Id. at 17-29.
160. Interim Report, supra note 7, at 1.
161. Id. at 3.
162. Final Report, supra note 8, at 23.
analytical work having been conducted, in particular, on the design of the ring-fence and the cost benefit analysis of the reforms proposed.\textsuperscript{163}

In introducing the Final Report, Sir John Vickers noted that the Commission had considered the recent deteriorating economic conditions over summer 2011 and associated regulatory developments within Europe and at the international level.\textsuperscript{164} Sir John restated the Commission’s earlier aim of creating a more stable and competitive U.K. banking system. This had to be less likely to cause or be susceptible to financial crises, avoid the taxpayer being responsible for the losses generated, and be more effective and efficient in providing the core services of safeguarding retail deposits, operating secure payments systems, and channeling savings to productive investments in the economy.

The ICB confirmed its provisional recommendations of requiring banks to hold more equity capital and loss absorbing debt and with retail banking activities being structurally separated within a retail ring-fence.\textsuperscript{165} Structural separation was stated to insulate vital retail banking services from global disturbances, to make it easier and less costly to resolve banks, and to improve competitiveness. The ring-fence would be strong but flexible. Only core mandated services would be permitted within the ring-fence; certain activities would constitute prohibited services, while others either being held within or outside the ring-fence at the bank’s option. Ring-fenced banks had to be self-standing subsidiaries with sufficient own capital, governance arrangements and independence, and with intra-group lending restrictions applying to protect the integrity of the ring-fence.

Equity capital levels for ring-fenced institutions would be increased to at least 10 percent of risk-weighted assets with corresponding limits on leverage and with ring-fenced and non-ring-fenced entities being required to hold an additional seven to 10 percent of loss absorbing capital in the form of convertible debt or “hail-in” bonds.\textsuperscript{166} Insured depositors would receive an automatic “depositor preference” on the insolvency of a ring-fenced bank.

The Commission remained concerned with the lack of competition within U.K. retail banking and especially with Personal Current Accounts (PCAs) and Small and Medium-Sized Enterprise (SME) banking services being over-concentrated. The divestiture of branches and business from Lloyds Banking Group (LBG) would be insufficient to allow the emergence of a strong challenger bank within the industry although the ICB did not recommend any increase in the European Commission’s original number of branches to be disposed. Customers should be able to transfer accounts between banks with an effective switching system being set up within two years and with service transparency being increased. The new FCA to be set up in the U.K. should be given a specific competition objective. The ICB did not recommend that banking markets be referred to the Competition Commission for independent investigation at that stage although a market investigation reference may be required if its other recommendations were not brought into effect by 2015. The ICB’s general recommendations should otherwise be implemented by the

\textsuperscript{163} INDEP. COMM’N ON BANKING, RESPONSES TO INTERIM REPORT (July 13, 2011) (U.K.), http://bankingcommission.independent.gov.uk/?page_id=835.


\textsuperscript{165} Final Report, mpra note 8, at 7-18.

\textsuperscript{166} Id. at 13.
beginning of 2019 in line with the new Basel Committee recommendations on bank capital adequacy and liquidity (Basel III).

The Final Report examined financial stability in terms of providing an overview of the Commission’s approach and proposals (Chapter 2)\textsuperscript{167} with a more detailed examination of its recommendations on the retail ring-fence (Chapter 3),\textsuperscript{168} loss absorbency (Chapter 4),\textsuperscript{169} and the economic impact and implementation of its financial stability reforms (Chapter 5).\textsuperscript{170} On competition, the Report contains an overview of relevant competition concerns, market assessment, and consequent recommendations (Chapters 6, 7, and 8).\textsuperscript{171} In addition to final recommendations (Chapter 9),\textsuperscript{172} the Report contains a glossary, a summary of responses to the Interim Report, a review of other financial stability and competition reforms, an assessment of the economic impact of the stability recommendations, and a response to criticism of the competition analysis set out in the Interim Report (Annexes 1–4).\textsuperscript{173}

The Government published its response to the ICB Report on December 19, 2011.\textsuperscript{174} The Chancellor of the Exchequer issued a statement on banking reform in the House of Commons.\textsuperscript{175} The Chancellor noted that Britain should remain one of the world’s leading financial centers with financial services employing 1.4 million jobs and the banking system being almost 500 percent of GDP.\textsuperscript{176} Action would accordingly be taken to strengthen the regulatory system with the creation of the FPC and PRA and with the Government undertaking to implement the principal recommendations of the ICB. The total amount of official support for the U.K. financial system during the financial crisis was stated to be £1.2 trillion by the National Audit Office (NAO).\textsuperscript{177} The Chancellor referred to this as “the British Dilemma” with the banking system providing vital services

\begin{itemize}
\item \textsuperscript{167} Id. at 23.
\item \textsuperscript{168} Id. at 35.
\item \textsuperscript{169} Id. at 79.
\item \textsuperscript{170} Id. at 123.
\item \textsuperscript{171} Id. at 165.
\item \textsuperscript{172} Id. at 233.
\item \textsuperscript{173} Id. at 253-356.
\item \textsuperscript{174} HM Treasury, The Government Response to the Independent Commission on Banking, 2011, Cm. 8252 (U.K.).
\item \textsuperscript{175} Rt. Hon George Osborne, Chancellor of the Exchequer, Banking Reform Statement by the Chancellor of the Exchequer (Dec. 19, 2011), http://www.hm-treasury.gov.uk/statement_chx_191211.htm.
\item \textsuperscript{176} Id.
\item \textsuperscript{177} One-hundred and twenty four billion pounds sterling was provided directly in funds including through the purchase of RBS Ordinary and B Shares (£45.8 billion), LBG shares (£20.6 billion), Northern Rock Plc. shares (£1.4 billion), Northern Rock (Asset Management) Loan (£21.6 billion), Bradford & Bingley Working Capital Facility (£8.6 billion), and other loans to support deposits (£26 billion). Nat’l Audit Office, HM Treasury, The Comptroller and Auditor General’s Report on Accounts to the House of Commons: The Financial Stability Interventions 8 (July 13, 2011) (U.K.). A potential liability of £1.03 trillion was also taken on through guarantees and contingent liabilities including in respect of Northern Rock (Guaranteed Liabilities of £24 billion, Contingent Capital of £3.4 billion, and unused Working Capital Facility of £3 billion) RBS and LBG (Asset Protection Scheme of £457 billion and Contingent Capital in RBS of £8 billion), as well as other sector-wide schemes, including the Credit Guarantee Scheme (£20 billion), Special Liquidity Scheme (£200 billion), Asset Backed Securities Scheme (£50 billion), Recapitalisation Fund (£13 billion), and unused facilities for loans to support deposits (£310 million). Id. at 6.
\end{itemize}
and the United Kingdom being an important global financial center while the total size of U.K. financial services could not be “underwritten by the British taxpayer.”

The Government supported the ICB key objectives of making banks better able to absorb losses, making it easier and less costly to sort out banks that get into trouble and to limit incentives for excessive risk-taking. A dual approach would be adopted through the ring-fencing of vital banking services and increasing banks’ loss absorbency. The Government agreed that vital banking services, and in particular retail deposits, should be provided through ring-fenced banks that should be prohibited from undertaking certain investment banking activities. Mandated services within the ring-fence would consist of retail and SME deposits and overdrafts with wholesale investment banking services being prohibited, although ring-fenced banks would be allowed to conduct certain ancillary services in support of their core functions. Ring-fenced banks would be legally and operationally independent and not dependent on the rest of the group for liquidity and solvency. Further work would be undertaken to implement all of the principles made with the Government also considering whether a de minimis exemption should be provided.

The Government supported the ICB’s recommendations on loss absorbency in addition to structural ring-fencing. Higher equity requirements would be introduced for large ring-fenced banks with necessary flexibility being obtained through E.U. measures. A minimum leverage ratio would be applied to all banks with a higher minimum ratio for larger banks. Resolution authorities would be provided with a statutory bail-in power to assist resolution with the Government working to ensure that equivalent provisions were adopted within European crisis management arrangements. Systemically important banks should hold a further amount of loss absorbing capital on a group-wide basis although non-U.K. operations may be exempt where there was no risk to U.K. financial stability. While the Government supported depositor preference, further work and consultation would be undertaken. A distinction was drawn between critical service protection and investor protection with losses being imposed on investors, including creditors, where necessary. All banks should be subject to normal competitive forces and be capable of necessary resolution without reliance on any implicit government guarantee and risking critical services. The Government would also adopt special resolution measures for investment firms and financial holding companies in addition to banks.

The Government accepted the ICB recommendations on improving competition especially through the creation of a strong and effective challenger bank with the Lloyds divestiture. Action would be taken to limit barriers to entry and anti-competitive prudential requirements, to improve switching, to enhance transparency, and to secure pro-competitive financial regulation. The government’s earlier perceived, implicit guarantee for “too big to fail” banks would be removed, which was stated to remove distortions within the European single market. The Government also accepted the Treasury Select Committee recommendation that the Payments Council should be brought within the scope of U.K. regulation.

178. See Gov’t Response to the Indep. Comm’r on Banking, supra note 174, ¶¶ 1.8-1.9.
179. Id. at 5.
180. Id. at 6.
181. Id. at 17 (discussing resolving investment banks); 19-20 (summarizing other U.K. and international financial regulation).
182. Id. at 8.

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The Government estimated that the aggregate private cost to U.K. banks of implementation of the ICB recommendations would be around £3.5 to £8.0 billion as against the £4.0 to £7.0 billion ICB figure. This should produce a gross reduction in the GDP of £0.8 to £1.8 billion, which was less than the £1.0 to £3.0 billion estimated by the ICB. The ICB claimed that its recommendations could reduce the annualized cost of financial crisis by up to £40 billion a year. The Government estimated that if other regulatory reforms reduce the probability of crisis by 30 percent and the ICB recommendations by a further 10 percent, the incremental economic benefit would be £9.5 billion per year even assuming an output loss of 25 percent.

Further primary and secondary legislation would be adopted to give effect to the ring-fence recommendations which would be enacted before the end of the current Parliament in May 2015, with banks being expected to comply as soon as practicably possible. A reasonable transitional timetable would be provided for. A White Paper is to be produced during 2012 containing detailed proposals on the implementation of the ICB recommendations.

VIII. Government Regulatory Policy

The Coalition Government has taken forward a number of other separate policy initiatives in connection with financial stability and financial growth more generally within the U.K. economy. This larger financial services policy agenda includes the institutional restructuring referred to with the creation of the FPC, PRA, and FCA, as well as the setting up and acceptance of the recommendations of the ICB under Sir John Vickers. The Labour Administration had earlier set up U.K. Investments Limited to manage the government’s interests in recapitalized banks with the distressed (toxic) assets of the largest banks being supported by a guarantee scheme through the Asset Protection Agency (APA). The FSA adopted a strengthened remuneration Code as part of its Handbook of Rules and Guidance. The Coalition Government has transformed the earlier Labour Administration one-year bonus tax into a permanent Bank levy generating around £2.5 billion per year. The Government has also been in discussion with the banks to ensure their adherence to its Code of Practice on Taxation, which promotes strong governance in this area and adopts a preventative approach to tax avoidance. Fifteen of the major U.K. banks had agreed to support the Code by November 2010.

These are important initiatives in attempting to ensure that the finance industry supports growth in the wider economy with higher standards of disclosure and best practice being adopted in certain key areas including remuneration, which will improve the rela-

183. Id. at 8-9.
184. Id.
185. Id. at 8.
186. Id. at 9.
187. Id.
188. Id. ¶ 1.7.
tionship between the public and financial firms. These initiatives are considered in further detail below.

A. U.K. FINANCIAL INVESTMENTS (UKFI) AND THE ASSET PROTECTION AGENCY (APA)

During the most severe part of the financial crisis in autumn 2008, the Government was forced to support the major U.K. banks and financial markets following the collapse in global and U.K. stock market prices. Prime Minister Gordon Brown and the then Chancellor Alistair Darling announced a three-part package of measures on October 8, 2008 which involved providing up to £50 billion bank recapitalization, £250 billion of wholesale funding guarantees, and a doubling of market liquidity to £200bn under the Bank of England’s Special Liquidity Scheme (SLS). Nineteen billion pounds were subsequently made available to RBS, £12 billion to Halifax Bank of Scotland (HBOS), and £5 billion to Lloyds TSB through the U.K. Bank Recapitalization Fund (BRF). While other major banks were able to raise capital from the markets, further funds had subsequently to be made available to the new Lloyds Banking Group (LBG following the merger of Lloyds TSB and HBOS) and RBS, which received £45 billion in total. The Government effectively assumed an 84 percent interest in RBS and a 43 percent interest in LBG.

Special competition dispensation had to be provided to create LBG due to its acquisition of 32 percent of the U.K. mortgage market. The Government’s investment in RBS and LBG are held through U.K. Financial Investments (UKFI) Limited, which was set up on November 31, 2008.

The Government was forced to set up a separate asset support scheme in January 2009 following continued volatility in the markets. The Troubled Asset Restructuring Program (TARP) had been approved in the United States in October 2008, which provided for the purchase of distressed (toxic) assets from major U.S. banks and other financial groups. While the first tranche of the TARP was used to provide additional capital for banks on a U.K. model, the provision of some form of asset support was considered in other countries. The Labour Administration in the United Kingdom decided to establish an insurance, rather than purchase, scheme that provided for public guarantees to be provided to cover possible losses on distressed assets retained on bank balance sheets. The new Asset

193. SCOTTISH AFFAIRS COMMITTEE, BANKING IN SCOTLAND, 2009-10, H.C. 70-I, at 10 (U.K.); UPDATES OF UFKI, supra note 192, at 8.
Protection Scheme (APS) was managed by the Asset Protection Agency (APA) that was established as an Executive Agency of the Treasury.\(^\text{197}\) The objectives of the APS are to support the stability of the U.K. financial system, to increase confidence and capacity to lend, and to support the economy by protecting participating financial institutions against exceptional credit losses on agreed asset portfolios.\(^\text{198}\) The overriding objective of the APA is to protect taxpayers' interests with its functions and responsibilities being set out in a Framework Document.\(^\text{199}\) The APA operates with a small permanent staff and relies on the operational cooperation of RBS, which was initially the sole participating bank. The APA Chief Executive is supported by an Advisory Board. The APA is legally part of the Treasury, although it operates on an arm's length basis as a separate executive agency.

The APA provides protection against future credit losses on defined asset portfolios in exchange for a fee. The APA provides protection against £282 billion of “Covered Assets” held by RBS. RBS accepted an initial uncovered First Loss Amount of £60 billion, with the Treasury paying 90 percent of any excess in the event of a “Trigger” event, including failure to pay, bankruptcy, or restructuring.\(^\text{200}\) RBS will have to pay £700 million per year in fees for three years and then £500 million per year until 2099 in the event of no prior disposal.\(^\text{201}\) RBS has to cooperate with the APA in ensuring that the assets covered are managed and administered in accordance with the Asset Management Objective (AMO), which is to maximize expected net present value (NPV) and minimize losses.

B. Remuneration Code

The issue of remuneration was considered by the FSA at an early stage during the crisis with a draft Remuneration Code being issued in 2009 and then further revised in 2010 under relevant E.U. rules that took effect on January 1, 2011.\(^\text{202}\) The FSA Code specifies a general requirement that remuneration policies must promote effective risk management with twelve more specific key principles in designing acceptable bonus packages for banks.\(^\text{203}\) The issue of Corporate Governance in U.K. banking was also considered by a separate review committee under Sir David Walker, former Executive Director of the


201. Id. at 32.


203. See FSA Handbook, supra note 9, § 19A.2.1, 1(3).
U.K. REGULATORY REVISION

Bank of England. The Walker Committee produced its final Review in July 2009, which identified five key themes and set out thirty-nine recommendations to strengthen governance, organization and practice within financial institutions. The application of equivalent recommendations to non-financial firms was considered separately by Sir Christopher Hogg, Chairman of the Financial Reporting Council (FRC) that was examining the application of the U.K. Combined Code on Corporate Governance for all listed companies in the United Kingdom.

Remuneration raises difficult and sensitive issues in public and private companies. Directors and managers should be properly incentivized and rewarded, provided that this does not distort risk taking and the fair distribution of profit within firms, including between staff and shareholders. Certain distortive elements had been allowed to be included within individual payment packages and especially with many calculations being carried out on a gross rather than a net earnings basis and with bonus payments being guaranteed. Much of this has since been corrected through the FSA Remuneration Code, which represents an intelligent and balanced package of designed guidelines. Larger governance structures have also been strengthened following the recommendations of the Walker Committee Review.

C. BANK LEVY

The Labour Administration in the U.K. announced in the 2009 Pre-Budget Report that a temporary Bank Payroll Tax would be imposed on bankers’ bonuses of 50 percent over £25,000 (equivalent to a 33.3 percent income tax). The Government had acquired an 84 percent stake in RBS and 43 percent stake in LBG, which made the high bonus payments announced politically sensitive. The temporary tax appeared to represent an intelligent compromise position while major financial groups remained within Government ownership. While some staff were transferred, or asked to be transferred, abroad to avoid the tax, many of the major institutions decided to pay amounts equal to the tax to retain key staff. The estimated income was approximately £3 billion. The Coalition Government later announced that they would replace the temporary tax with a permanent Bank Levy on U.K. bank balances and building societies starting on January 2011. This was justified based on the need for banks to contribute to the supposed costs of the support that they received from the Government on an implied basis rather than to limit bonus payments directly.

205. See DAVId WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES 8-18 (July 16, 2009).
206. See id. at 10-18 (including recommendations related to board size, composition and qualification, board function and evaluation of performance, institutional shareholder role, communication and engagement, risk governance, and remuneration).
208. See Seely, supra note 189, at 1, 6.
209. BANKING IN SCOTLAND, supra note 191, at 10; UPDATES OF UFKI, supra note 192, at 8.
The permanent Bank Levy was confirmed in the June 2010 Budget. A consultation document was issued on July 13, 2010 with a response document on October 21, 2010 to which was attached initial draft legislation. The levy would be included as a Schedule to the Finance Bill (No. 3) for 2010. The levy would be based on total chargeable equity and liabilities as reported on the relevant balance sheets of the banks and banking and building society groups affected. This would operate on a balance sheet model above £20 billion. The levy was set at a rate of 0.05 percent for 2011 and 0.075 percent for 2012. The levy would be charged through existing corporation tax using the Quarterly Installment Payments (QIPs) system.

The Government argued that the levy was based on that proposed by the IMF in its Report to the G20 titled *A Fair and Substantial Contribution by the Financial Sector* in June 2010. This discussed the possible creation of three new charges with a Financial Stability Contribution (FSC or bank tax), a Financial Activities Tax (FAT), and a Financial Transaction Tax (FTT). The U.S. Obama Administration proposed a Financial Crisis Responsibility Fee of $90 billion over ten years on U.S. banks with assets of more than $50 billion. The U.K. bank levy was claimed to be justified based on the perceived need to ensure that the banking sector makes a fair contribution that reflects the risks they pose to the financial system and wider economy.

The proper justification for a bank levy remains unclear. A levy, or FSC, only reflects the Government’s potential contingent liabilities to support the financial system in the event of an extreme crisis that will exist in any case. This arguably also simply reflects the benefits that society receives from the financial industry in terms of the functions

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214. Id.


216. See A Fair and Substantial Contribution, supra note 215, at 7. The FSC could be imposed on liabilities or assets or both at either a flat or variable rate. Id. The FAT would be imposed on bank profits and remuneration taxes. Id. The FTT could be imposed on a defined range of financial instruments or transactions including currency positions, stocks, bonds and financial derivatives. Id. at 19. The FTT constitutes a form of “Tobin tax” as originally proposed by The Economist Tobin. Id. The FTT had been supported by the German Government at the November 2009 G20 Financial Ministers meeting in Scotland, although this was rejected. See id. at 19-21.

217. Id. at 7.

218. See Bank Levy: A Consultation, supra note 211, ¶ 1.7. “The Levy is intended to ensure that banks make a contribution that reflects the potential risk to the [U.K.] financial system and wider economy from bank failures and consequent loss of consumer and investor confidence.” Id. ¶ 1.8.

carried out. Unless the levy is used to fund a resolution mechanism or otherwise prevent crises or support crisis management, it cannot be considered to improve financial stability as such. It otherwise only constitutes an alternative form of a business or corporation taxation.

D. Project Merlin

The Government announced the conclusion of negotiations over Project Merlin on February 9, 2011 after an extended negotiation period.\(^{220}\) A separate statement was issued by Barclays, HSBC, LBG, and RBS collectively on February 9, 2011.\(^{221}\) The objective was to secure a commitment to increase lending to businesses and, in particular, small and medium sized enterprises (SMEs) from £179 billion in 2010 to £190 billion in 2011.\(^{222}\) Seventy-six billion pounds would be made available to SMEs directly, which represented a 15 percent increase from 2010.\(^{223}\) The Bank of England would monitor the banks' aggregate gross new lending with the results being published on a quarterly basis. Aggregate bonus pools would also be reduced from 2009 with the bonuses paid to the five highest paid senior executive officers being published annually on an unnamed basis. Additional support of around £1.2 billion would be made available to support regional growth with £200 million being provided over two years to assist set up the Government's proposed “Big Society Bank.”\(^{224}\) The Treasury considered that the measures constituted a demonstration by the banks of their social responsibility and support for U.K. businesses.

In entering into the agreement, the banks stated that they “explicitly [recognized] their responsibility to support economic recovery” with key commitments on lending, tax, pay, and other economic contributions.\(^{225}\) Corresponding undertakings were nevertheless expected from the Government. The banks expected a commitment by the Government to “the [stabilization] and improvement of the relationship between the Government and the banks” as well as “the creation of a level playing field internationally for [U.K.] banks” (consistent with G20 commitments) and the acceptance of the “right of self-determination by bank boards” subject to increased shareholder engagement.\(^{226}\) The objective was to reverse the continuing anti-financial sector “bank bashing” position adopted by the Government and its use of this position for political and media advantage.\(^{227}\)

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221. Id.
222. Id.
223. Id.
224. Id.
226. Id.
E. Code of Practice on Taxation

The major U.K. banks further agreed to comply with HMRC’s Code of Practice on Taxation for Banks under their February 2011 Project Merlin Statement.228 The purpose of the Code was to encourage banks to adopt certain best practices with regard to taxation management.229 Banks may undertake appropriate tax planning to support their business needs, although they should not engage in tax avoidance.230 The Chancellor expressed the Government’s commitment to ensuring that the banking sector maintained strong governance on taxation with banks adhering to the Code by November 2010.231 Fifteen major U.K. banks confirmed their adherence to the Code.

IX. U.K. Regulatory Comments and Conclusions

A substantial amount of regulatory reform has been announced in the United Kingdom since the General Election in May 2010. Much of this has been more institutional and structural rather than substance based until now. In institutional terms, the role and function of the Bank of England has been strengthened further with the establishment of the separate FPC and PRA within the Bank Group, as well as with the creation of the FCA as a separate independent agency. Some structural separation has also been proposed by the ICB with the creation of retail ring-fences within the larger banks and groups.

These reforms have also been brought forward as part of a larger policy framework that includes a continuing bank investment program, bank levy and bank lending arrangements, and strengthened requirements on bank bonuses and remuneration. Supervisory approach has also been made more interventionist with arrangements having to be made to implement Basel III and other international and European reform agenda in the United Kingdom.

The following more specific comments and conclusions may be drawn on the most recent U.K. reforms at this time.

A. Crisis Reaction and Opportunity

The outgoing Labour Administration had already brought forward a number of initiatives in response to the emerging financial crisis and subsequent events. The crisis in the United Kingdom was principally contained with the announcement of the U.K. three-point plan produced by Prime Minister Gordon Brown and the then Chancellor Alistair Darling on October 8, 2008 that involved up to £50 billion bank recapitalization, £250 billion of wholesale funding guarantees, and a doubling of market liquidity to £200 billion under the Bank of England’s Special Liquidity Scheme (SLS).232 The Government had separately supported the merger of Lloyds TSB and HBOS on September 17, 2008 and had set up in early 2009 a distressed (toxic) asset guarantee scheme based on insuring

228. Project Merlin—Banks’ Statement, supra note 225, at 3.
229. HM Revenue & Customs, Code of Practice on Taxation for Banks 19 (June 2009).
230. Id. at 15.
assets on the balance sheets of the banks in return for a fee rather than outright asset purchases as proposed by the original TARP in the United States.233

The Labour Administration established a comprehensive Special Resolution Regime (SRR) that included private bank transfer, bridge bank transfer, and public acquisition (or nationalization) options, as well as a separate special Bank Administration Procedure (BAP) and Bank Insolvency Procedure (BIP) under the Banking Act 2009 which also created the CFS.234 A number of other reforms were introduced under the Financial Services Act 2010, which included confirming an express financial stability objective for the Bank of England.235 The FSA had adopted a separate Supervisory Enhancement Program (SEP) following its investigation into the collapse of Northern Rock and had incorporated a considerably strengthened Remuneration Code within its Handbook.236 It had also produced its own considerably more onerous liquidity proposals, than those proposed by the Basel Committee under Basel III, with the Government committing to implement the higher capital requirements proposed by the ICB than would be adopted under the E.U. CRD IV in Europe or Basel III globally.237

It is arguable that the reforms already adopted in advance of the May 2010 election may have been sufficient to contain and respond to any future crises. The new Coalition Government nevertheless took the opportunity to strengthen these measures again with further institutional reforms and announced the replacement of the CFS with the FPC within the Bank of England and of the FSA with the PRA and FCA.238 The effect of this has been to create a new central-bank-based macro-prudential model with the regulatory delegation of non-systemic functions to an external agency. A more aggressive and interventionist supervisory approach and culture would also be adopted, although much of this had already been put in place by the FSA with its SEP, new product design regime, and credible enforcement program. While many of these reforms were directed at financial stability, they were also to a significant extent politically driven.

B. TWINS PEAKS

The new U.K. system has been described as being based on the “Twin Peaks” model as discussed in earlier literature and as adopted with some amendment in Australia following the Wallis Commission Report.239 The new U.K. regime was nevertheless initially “Tri or Tripled Peaked” with the creation of a separate prudential agency (the PRA), the original

233. See supra note 196.
239. See FIN. SYS. INQUIRY, COMM. UNDER STAN WALLIS, FINAL REPORT (Mar. 1997) (Aus.).
Consumer Protection and Markets Authority (CPMA, later renamed the FCA), and a separate financial enforcement authority. The Government subsequently decided to abandon the third agency and retain financial crime within the FCA, which would also be responsible for consumer protection and stock market and exchange oversight. Macropraudential policies are also now dealt with through the FPC, with prudential and conduct regulation being managed by the PRA and FCA. While the FPC and PRA are still within the larger Bank Group, the U.K. model is essentially still tripartite or, at least, only partially twin peaks based.

The advantage of this model is that it creates a much stronger and more effective core macro-prudential function at the same time as a single set of decision making, responsibility, and accountability lines within the central bank, which is responsible for monetary, regulatory, and wider market oversight policy. Splitting prudential and conduct functions is also intended to allow each to be carried out in a more specialized and dedicated manner, although this could possibly have been dealt with by having separate teams or divisions within the FSA. The difficulty that would have arisen in this case is that the Bank of England would then have been administratively and operationally overloaded if it had become responsible for monetary, regulatory, and macro-prudential, as well as payment and market infrastructure, policy. It was for this reason that the decision was made to transfer non-core systemic functions to the FCA. While some systemic concerns may still arise with regard to markets and exchanges under FCA oversight, a functional compromise had to be achieved in dividing respective regulatory functions between the PRA and FCA.

The unfortunate, but inevitable, consequence of splitting previously integrated regulatory functions between two agencies means that a number of additional institutional, administrative, and operational compromises have had to be adopted, making the underlying legislative framework considerably more complex. A substantial amount of negotiation effort, for example, within the Treasury Select Committee and Joint Parliamentary Committee had focused on ascribing the correct functions to each agency and ensuring that they operate in a complementary and supportive manner. Effective exchange of information and coordination arrangements have also had to be designed with two further Memoranda of Understanding (MoU) having to be drafted. A considerable amount of daily operational overlap will occur in practice with inevitable policy conflicts and contradictions arising. A further unintended consequence has been the remuneration in dividing responsibility between the PRA and FCA for representation on various European and international committees where their own functions and mandates overlap. This will require considerable care and attention in practice.


C. Financial Stability

The new U.K. model has been designed to create a central bank based macro-prudential model. The advantage is that core systemic and financial system policies and functions will be centered within the central bank. The Bank will then be responsible for monetary, regulatory, and macro-prudential, as well as payment systems and infrastructure, policies. The evident danger is that conflicts may arise between the policies, although their centralization within a single institution may allow for speedier and more effective resolution and reconciliation. This centralization of authority has also necessitated the establishment of strengthened internal governance and external oversight and accountability arrangements to ensure that the Bank is capable of discharging its several functions in a proper, balanced, independent, informed, and effective manner.

The Coalition Government had criticized the earlier tripartite system for resulting in confusion of the roles and ultimate decision-taking responsibility of the Treasury, Bank of England, and FSA with each having equal status. It is arguable that the functions of the three separate agencies were already sufficiently clear under the earlier MoU that was entered into between them in 1998 and revised in 2006 and that any decision errors during the crisis were more to do with timing, complexity, or simply individual personalities rather than with the nature of the underlying committee mechanism itself. The danger of the new regime is that the earlier balance between the three agencies has been removed with an over-centralization of authority in the Bank. It was principally for this reason that the Bill has been amended to confer on the Chancellor a statutory right to issue directions to the Bank in the event of another major crisis, with the relationship between the Treasury and Bank still being governed by a new MoU on Crisis Management. The new policy would accordingly appear to amount more to one of “institutional and operational substitution” rather than clear and quantifiable “replacement or improvement.” Much will depend on how this is implemented and operates in practice and, in particular, under the new MoU to be adopted.

D. Macro-Prudential Oversight

The recent crises in financial markets drew clear attention to the failure in most countries to monitor wider threats to market and systems stability. Risks and exposures were allowed to build up in parts of the retail and wholesale markets that were not properly supervised or regulated. Regulators claimed, in retrospect, that they were only responsible for the micro-institutional supervision of firms on an individual or solo basis while central banks argued that they had no express authority or tools to deal with the wider macro-prudential risks that they had already identified. A number of initiatives have since been adopted to construct new macro-prudential regimes, such as with the FPC in the United Kingdom, the Financial Stability Oversight Counsel (FSOC) set up under the

Dodd-Frank Act in the United States, and European Systemic Risk Board (ESRB) in the European Union.

These are important initiatives although significant difficulties remain with regard to constructing an effective macro-prudential function in practice. Initial problems arise in defining “financial stability” and “financial instability,” as well as the appropriate tests for intervention, and in identifying the necessary data and information that has to be properly collected, examined, and assessed. Where risks can be properly isolated, measured, and assessed, further problems arise in agreeing on the necessary tools to apply. Existing proposals, in particular, in the advanced economies have unfortunately often simply tended to focus on raising capital adequacy further beyond existing Basel III levels, which may only constrain bank lending and underlying market function disproportionately.

It has also often been assumed that the new macro-prudential agent should have direct regulatory powers and authority. Effective macro-prudential function will nevertheless involve monitoring a range of policies including monetary, regulatory, consumer protection, competition, and fiscal and economic policies together. Where an exposure arises in a particular policy area, it may be more effective to have any specific response dealt with by the particular agency concerned. The focus should possibly then be on macro-prudential “oversight” or supervision rather than direct regulation with macro-prudential control or regulation being dealt with on a delegated rather than direct basis.

The effectiveness of the macro-prudential oversight undertaken may, in practice, ultimately be dependent on the quality of the day-to-day information collection and assessment undertaken and supporting inter-agency cooperation and coordination secured. The Bank of England had a separate Financial Policy division, or wing, before the crisis, and this is to be strengthened with the transfer of equivalent monitoring activities from the FSA. The FSOC in the United States will be supported by the Office for Financial Research (OFR) within the Treasury, which will retain its own Data Center and Research and Analysis Center. Separate work has already been undertaken in identifying possible relevant data models, or matrices, that may be used.

Domestic efforts will also have to be coordinated with other cross-border systems, such as with the separate new financial committee set up in the European Union with the European Banking Authority (EBA), European Markets and Securities Authority (EMSA), and European Insurance and Occupational Pension Authority (EIOPA), as well as with the IMF, BIS, and FSB at the international levels.


249. Reform and Regulation: The Government’s Approach, supra note 240.


The 2011 Financial Services Bill will on enactment create the new statutory regime for financial regulation within the United Kingdom. Rather than preparing a separate, clean, and integrated new statute, it was decided to proceed by way of statutory amendment of the earlier FSMA rather than new full statutory replacement. This is unfortunate from a policy and access perspective in that the consolidated statute has become exceptionally more complex and difficult to follow. This is also more politically questionable in that it suggests that the new regime is not as fundamentally revolutionary as claimed. This nevertheless only reflects the regulatory reality of the reforms adopted. These are essentially based on key aspects of institutional revision with some supervisory adjustment. While separate handbooks will be produced by the PRA and FCA, much of the substantive content of the earlier integrated regulatory regime may remain constant and in place.

As with the earlier FSMA, the Financial Services Bill is also largely constitutional in content because it specifies the functions of each of the key agencies involved and determines their respective powers and authority. Almost all of this is achieved through amendments to the Bank of England Act 1998 and FSMA in Parts 1 and 2 of the Bill. Inquiries and investigations are strengthened under Part 5 with the resolution regime under the Banking Act 2009 extended under Part 7. The only new provisions are with regard to mutual funds in Part 3 and complaints in Part 6 with the Chancellor’s powers of direction in Part 4, although again much of this simply provides statutory recognition for the early arrangements set out under the original tripartite MOU, albeit strengthened and clarified.

F. SUPERVISORY AND REGULATORY POLICY

The Treasury, Bank, and FSA have stressed the novelty of the new “regulatory approach” to be adopted by the PRA and FCA. This has been referred to in each of the Government’s consultation papers and the recent joint regulatory approach statements issued. These documents set out the basis for a much more aggressive, interventionist, and determinist supervisory approach. This had been referred to in the Turner Report and given effect under the FSA’s SEP and credible deterrence enforcement policy, with

252. See generally Financial Services Bill, 2010-12, H.C. Bill [278] (U.K.). The Financial Services Bill has subsequently been revised by both Houses of Parliament.
254. See id.
255. See id. pts. 1, 2.
256. See id. pts. 5, 7.
257. See id. pts. 3-4, 6.
258. See id. pts. 3-4, 6.
the FSA considerably increasing the severity of fines and penalties imposed since the crisis. The FSA had earlier introduced and expanded its More Principles Based Regulation (MPBR) approach using general principles rather than detailed rules.261 The FSA has also produced new papers on such important policy matters as product regulation262 and Treating Customers Fairly (TCF)263 that have imposed additional new obligations on firms and raised their oversight functions. Outgoing FSA Chairman Hector Sants had also issued a number of speeches on the FSA adopting a more direct approach with regard to promoting appropriate regulatory culture, including the area of financial ethics.264

Before responsibility for bank supervision was transferred from the Bank of England to the FSA under the Bank of England Act 1998, the supervisory approach adopted was often described as being based on “moral suasion.”265 This relied con either the non-legal or non-statutory moral or market authority and reputation of the Bank.266 The perceived advantages of this system were its informal contact and judgment or discretionary based nature. The idea of judgment and discretion has been re-used in the statements on the Bank’s and PRA’s new regulatory approach.267 The new regulatory approach adopted accordingly represents a composite of the more-interventionist FSA and judgment based Bank approaches. All of this is to be welcomed, although it remains unclear how different this will be from the already revised supervisory and regulatory practices adopted by the FSA following the crisis and before its imminent dissolution.


266. See id.

267. BLUEPRINT FOR REFORM, supra note 3, at 7.
G. Resolution

A considerably strengthened resolution regime has been adopted in the United Kingdom under the Banking Act 2009.268 This provided for the creation of three core new Special Resolution Regime (SRR) options with a private bank transfer, temporary “bridge” bank transfer (on a U.S. model), and public acquisition (nationalization).269 The Act also amends the existing laws to create a separate special Bank Administration Procedure (BAP) and supporting Bank Insolvency Procedure (BIP).270

In practice, statutory special resolution will only work after banks’ and financial institutions’ own internal Restructuring and Recovery Plans or Programs (RRPs) have failed. All major financial institutions are being required to prepare internal contingency plans with RRPs, which are often referred to “living wills” in the United Kingdom and European Union or “funeral plans” in the United States.271 The FSB has issued a recent paper on the content of pre-crisis internal living wills and post-crisis resolution regimes that it collectively refers to as RRPs.272 The FSB has also issued a number of other papers strengthening supervisory oversight and the regulatory treatment of SIFIs and G-SIFIs.273

While “Too Big To Fail” remains an important problem in all countries and at the cross-border level, this should be of less significance going forward with the range of initiatives that have already been undertaken to strengthen risk management, increase capital, liquidity and leverage standards, and improve pre-crisis internal restructuring RRPs and post-crisis resolution SRRs of major financial institutions and groups. This should substantially reduce the need for market support and fiscal bailouts.

H. Market Support

While major crises should be limited through the range of mechanisms referred to, market support may still be required in the most extreme situations. The lack of effective specific support mechanisms may have been considered to have significantly aggravated key stages of the recent crisis. The Federal Reserve and Treasury claimed that they lacked the necessary authority to support Lehman Brothers in September 2008 while the Bank of England had earlier been advised that it could not provide covert support to Northern Rock following its request for emergency assistance in August 2007. A range of ad hoc measures had to be subsequently adopted during the crisis, especially in the United States. The Bank of England has issued one statement on this issue that refers to the need to have

268. See generally Banking Act 2009 (cl. 1) (U.K.).
269. See id. pt. 1, §§ 8-9.
270. See id. pt. 1, §§ 90-168.
271. See DELOITE, POSITIONING FOR A NEW FINANCIAL LANDSCAPE: ROLLING OUT A RECOVERY AND RESOLUTION PLAN 2 (2010) (citing FINANCIAL STABILITY FORUM, FSF PRINCIPLES FOR CROSS-BORDER COOPERATION ON CRISIS MANAGEMENT (2009)).
273. See, e.g., FSB, POLICY MEASURES, supra note 93, at 1; FSB, EFFECTIVE RESOLUTION, supra note 91, at 7; FSB, FSB RECOMMENDATIONS AND TIME LINES, supra note 93, at 1-2; FSB, INTERIM REPORT TO G20 LEADERS, supra note 93. See also ASSESSMENT OF THE MACROECONOMIC IMPACT, supra note 93; GLOBAL SYSTEMICALLY IMPORTANT BANKS, supra note 93; Measures for Global Systemically Important Banks, supra note 93; GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, supra note 93; A COMMON DATA TEMPLATE, supra note 93, at 2.
appropriate mechanisms in place where necessary.\textsuperscript{274} Care has to be exercised to ensure that markets realize that such mechanisms will only be used in the most extreme cases and on a discretionary basis to limit the dangers of moral hazard, excessive reliance, and risk-taking. The availability of such mechanisms will nevertheless always be important in reassuring markets and in preventing wider systemic contagion and collapse in the most extreme cases.

I. COMPETITION AND STRUCTURAL REGULATION

The U.K. Government has been concerned with the need to increase consumer protection and competition following the crisis. It was for this reason that the ICB was established with both issues being examined on an independent and an authoritative basis. The Interim and Final Reports of the ICB made a number of recommendations with regard to improving regulation and increasing competition.\textsuperscript{275} The ICB specifically proposed the adoption of retail ring-fencing in the United Kingdom, with ring-fenced activities also being supported by higher capital charges of around 10 percent and with other investment banking activities being left to be dealt with under relevant international Basel Committee standards.\textsuperscript{276} The Commission has also recommended the further divestment of branches by the Lloyds Banking Group (LBG) that it considers to have grown too large following the merger of Lloyds TSB with HBOS.\textsuperscript{277}

The Commission rejected any full separation of commercial and investment banking on an earlier U.S. Glass-Steagall model with the retail ring-fence representing an apparently intelligent compromise.\textsuperscript{278} This will placate public and media calls for higher protection of retail functions without disproportionately undermining the competitive position of larger banks and complex groups. The idea of structural ring-fencing (or “functional isolation” or “functional separation”) is highly useful, although this may have been better used to protect all critical functions within all banks and not simply in respect of retail and SME customers. This may then have little effect in protecting financial stability in practice and may be considered to be more of a consumer protection measure while retail and SME customers have already been given higher deposit insurance protection payouts in any case. It may also have been more appropriate to apply the increased 10 percent charge to the higher-risk, non-retail, and investment banking activities, although this may still be absorbed within the total new Basel III capital framework within the proposed 0 to 2.5 percent counter-cyclical or 0 to 3 percent systemic risk charges.\textsuperscript{279} Reasonable competition should also always be promoted in the financial area, although care has to be taken to ensure that markets do not become overly competitive with aggressive outliers reducing standards elsewhere, such as with the sale of subprime loans in the United States or offer-


\textsuperscript{275} See Final Report, supra note 8, at 10-11, 16; Interim Report, supra note 7, at 51-60.

\textsuperscript{276} See Final Report, supra note 8, at 10-11.

\textsuperscript{277} See id. at 16.

\textsuperscript{278} See id. at 66.

\textsuperscript{279} See Basel Committee, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems 63-64 (June 1, 2011).
ing of exceptionally low loan-to-value (LTV) ratios and mortgage applications by Northern Rock in the United Kingdom.

J. WIDER FINANCIAL POLICY REFORM

The Government has undertaken a number of further policy initiatives to support long-term growth and contribution, including through its asset protection facility, independent bank shareholding, Bank Levy, Project Merlin lending support and bonus and remuneration commitments, and the Taxation Code.

The U.K. asset insurance facility, set up under its APA in 2009, represents an important model for managing distressed assets in other countries in the future. This allows the assets to remain on a bank’s balance sheet, which avoids any difficulties in agreeing on disposal prices while the bank receives protection cover, reduces its regulatory capital obligations, and supports its share price. The U.K. scheme has also been successful in establishing a close operational relationship between the APA and the Royal Bank of Scotland (RBS), in particular, in monitoring and managing the £282 billion covered asset portfolio created for RBS.280 This will assist to ensure that the manner in which the assets are managed, controlled, documented, and processed will be improved over time.

The agreement eventually reached on Project Merlin represented an intelligent and balanced compromise position between the banks and the Government that provided for the provision of reasonable credit, subject to market conditions, and executive pay commitments without undermining internal bank governance and autonomy. The Government has nevertheless since decided to replace this with the more direct £20 billion National Loan Guarantee Scheme.281 Banks should have no difficulty in adhering to the Taxation Code, provided that this is not used by the tax authorities to impose substantial additional charges without proper due process and a clear legal basis.282 More significant concerns arise with regard to the permanent Bank Levy, which does not support financial stability in any direct manner and arguably only constitutes a form of additional business or corporation tax. This also contributes to creating a larger climate of over re-regulation and penalty that may limit bank recovery and lending contrary to the Government’s stated policy in this area.

The U.K. bank capitalization program assisted stabilizing the banks’ financial positions as their share prices were falling. The Government principally purchased non-voting preferred stock that produced a reasonably generous return without interfering with the internal operations of the banks. These holdings were then managed through U.K. Investments that acted on an independent, arm’s length basis. The Government’s investment in the banks will be disposed when the share prices recover sufficiently to produce a reasonable profit or politically acceptable loss. Contradictions did arise in the management of the scheme with the Government being placed under considerable political pressure at the beginning of 2012 to use its 83 percent and 43 percent share positions in RBS


281. See AUTUMN STATEMENT 2011, supra note 11, at 7.

282. See Megan Murphy et al., Barclays Faces Block on Tax Schemes, FIN. TIMES (Feb. 27, 2012, 8:55 PM), http://www.ft.com/cms/s/0/a810760-6173-11e1-94fa-00144feabdec0.html.
and LBG, respectively, to limit bonus payments contrary to its non-interventionist and open-market principles.  

K. INTERNATIONAL AND E.U. POLICY IMPLEMENTATION

The United Kingdom will also implement all of the principal international regulatory reform and other E.U. measures adopted following the crisis. These principally include the Basel Committee’s Basel III enhanced capital and new global liquidity and leverage requirements. These will specifically be converted into relevant E.U. requirements, in particular, with the further revised Capital Requirements Directive (CRD IV), although a number of Member States attempted to dilute some of these provisions in advance of domestic implementation to favor local institutions. A substantial number of other E.U. measures have also been adopted, or proposed, that will have to be implemented in the United Kingdom. These include the Alternative Investment Managers Directive (AIFMD), which created a new registration and oversight regime for hedge funds, and the Credit Rating Agency Regulation. The earlier Markets in Financial Instruments Directive (MiFID) is being reviewed with the 2010 Market Infrastructure Regulation (EMIR), which includes measures to strengthen controls on over-the-counter (OTC) derivatives and credit default swaps, including through the use of Central Counterparties (CCPs). The operation of the other core provisions is also being reconsidered, such as the Pro-


284. See A GLOBAL REGULATORY FRAMEWORK, supra note 279, at 2. Core Tier 1 capital (paid up share capital and retained earnings) is to be increased from 2 percent to 4.5 percent, with a conservation buffer of 2.5 percent, which increases the core Tier 1 ratio to 7 percent. Id. at 28, 69. A discretionary 0.0 to 2.5 percent counter-cyclical buffer is also to be applied with a further systemic risk buffer of approximately 2 percent to 3 percent for larger banks and financial groups. Id. at 58. A new 3 percent Tier 1 leverage ratio has also been introduced. Id. at 61. See Basel Comm. on Banking Supervision, Basel III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MANAGEMENT, STANDARDS AND MONITORING 1 (Dec. 2010). 285. See Proposal for a Directive of the European Parliament and of the Council on the Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms and Amending Directive 2002/87/EC of the European Parliament and of the Council on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate, at 9, COM (2011) 453 final (July 7, 2011), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0453:FIN:EN:PDF (describing the E.U. legislation in force and new proposals related to capital requirements for credit institutions and investment firms).


spectus, Transparency, and Market Abuse Directives. It has to be expected that the European Commission will monitor other international and national developments, such as those in the United States and all of the measures to be brought into effect under the Dodd-Frank Act and implementing rules. E.U. Commissioner Michel Barnier has referred to the European Union adopting over forty-seven measures in the financial area, all of which will have to be transposed and converted into U.K. law.

L. MARKET AND REGULATORY BALANCE

The core challenge within the United Kingdom and elsewhere has been to attempt to achieve an appropriate balance between effective regulatory control and underlying market function. This has specifically involved reconciling the needs of financial market earnings and innovation as against financial market stability, as well as with efficient financial markets and wider growth and recovery in the real economy. Any disproportionately aggressive, and ultimately ineffective, re-regulation may only limit wider economic growth and prosperity. Difficult policy decisions arise in this area while governments also have to attempt to reconcile efficient debt management and fiscal budgetary discipline with industrial, manufacturing, and service growth and recovery. Financial markets carry out key functions without which the rest of the economy could not operate. The post-crisis challenge should not be to continue to punish financial institutions for earlier apparent failures or fault, but rather be to attempt to restore underlying core market functions and services.

X. U.K. Regulatory Close

The reforms announced by the Coalition Government since its election in May 2010 in the U.K. constitute an important and significant experiment in institutional reform within a new larger extended regulatory reform agenda. A number of interesting and valuable initiatives have been taken forward. Substantial institutional change nevertheless necessarily involves a corresponding number of institutional compromises. It has to be accepted that institutional revision may be of limited effect by itself without further, more substantial regulatory and operational supervisory changes. This is a bold new experiment and it remains to be seen how it unfolds over time.

The new program is based on a number of key new elements. The role of the Bank of England has been strengthened with three new agencies being created with the FPC, PRA, and FCA and with consumer education and financial capability already having been transferred to the CFEB. The effect is to create a new central-bank based macro-prudential model with the delegation of non-systemic regulatory function to an external agency. A strengthened supervisory and enforcement policy has been adopted with some qualified


structural regulation proposed with the new retail ring-fencing recommended by the ICB and with CCPs for OTC derivatives under supporting E.U. measures. All of this has been built into a larger mixed critical function and economic growth framework to operate with the Government’s continuing austerity and deficit reduction package.

It is hoped that all of this should be sufficient to allow markets to continue to develop and innovate, but in a more safe and stable manner and in a way that can support larger economic growth and prosperity. The core challenge remains to balance financial innovation and stability with immediate financial market income and benefit, but also wider economic and social advantage and improvement. Financial markets are key drivers within any economy, and growth will be impossible without their continued contribution and support. A degree of regulatory review and re-regulation is necessary following the devastating effects of the recent crises, although underlying market function and market advantage must still be preserved.

The two key residual regulatory issues that have to be dealt with in all economies are in connection with containing the potential damaging effects of SIFIs and G-SIFIs as well as in constructing effective wider macro-prudential oversight and support regimes. The dangers of too big to fail with SIFIs and G-SIFIs can principally be dealt with through improved risk management and strengthened capital, liquidity, and leverage, as well as effective pre-crisis and post-crisis resolution mechanisms. All of this has been implemented in the United Kingdom under the reforms announced by the outgoing Labour Administration and statutory changes brought into effect under the Banking Act 2009 and Financial Services Act 2010. Macro-prudential function will now be brought forward under the new FCP model created. One significant omission remains in terms of market support. While it has to be hoped that all of the new macro-prudential oversight and resolution mechanisms, especially with regard to G-SIFIs and GSIBs, will be sufficient to prevent any further future systemic threats from arising, it will still be essential to have in place necessary extended market support facilities, beyond more traditional LLR, in the event of an extreme crisis arising, such as through cross-border or inter-regional disturbances or more simple technical or electronic transmission and contagion.

It remains to be seen how all of this will further evolve and operate over time. A substantial post-crisis reform package was constructed before the May 2010 election, although this will be further strengthened through the additional institutional changes announced and, in particular, with the creation of a powerful new macro-prudential model at the core of the system. This will provide an alternative option to the multi-agency, collective, or composite U.S. model with its FSOC and the inter-agency and cross-border E.U. ESRB. All of these still provide important institutional choices for consideration and adoption in other countries or regions. Many of the key lessons from the crisis have been recognized and acted on in the United Kingdom, United States, and elsewhere. These measures may not prevent further future crises as such, although they may be sufficient to avoid the devastating market and wider economic and social damage caused by the last crisis. We can only hope so.
Transnational Dealings—*Morrison* Continues to Make Waves

**Marc I. Steinberg** and **Kelly Flanagan**

Abstract

*Morrison v. National Australia Bank Ltd.* drastically altered the landscape for transnational securities litigation and the way that courts determine proper application of a statute concerning a transnational claim. The Supreme Court’s characterization of extraterritoriality under the Securities Exchange Act as a merits-based inquiry has led to a reexamination of limitations under other federal statutes that were previously thought to be jurisdictional issues. Significantly, *Morrison* created a roadmap for courts to follow when the extraterritoriality of a statute is questioned. The key to proper application of a statute is to decipher the minimum U.S. contacts required to state a transnational claim. The tests developed addressing this inquiry are critical in discerning the boundaries of U.S. law at a time when transnational dealings are prevalent.

I. Introduction

The Supreme Court in *Morrison v. National Australia Bank Ltd.*, significantly altered the treatment of transnational securities claims. This article explores *Morrison’s* impact, including trends that may emerge and questions that remain. The article commences with an analysis of this important decision. Thereafter, the widespread implications of *Morrison’s* merits-based characterization are addressed. The article then considers how *Morrison* affects extraterritorial claims under other federal laws. Lastly, there is a detailed analysis of the types of securities claims that endure after *Morrison*. The article’s focus is how *Morrison* will have longstanding effects on both U.S. federal securities and non-securities law.

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1. 130 S. Ct. 2869 (2010).

A. Pre-Morrison—The Calm Before the Storm

Understanding the background of section 10(b), which is the principal antifraud provision of the Securities Exchange Act, and its application to transnational securities fraud sets the stage for Morrison. Prior to Morrison, lower federal courts held that section 10(b) was silent as to extraterritorial application. When transactions with an international connection arose, courts considered whether there was subject-matter jurisdiction under section 10(b) to adjudicate the claim.

In determining extraterritorial applicability, lower federal courts focused on policy matters such as the possible creation of a U.S. haven for those defrauding foreign investors and Congress’s intent to establish a high standard of conduct in securities transactions. Also significant, the Second Circuit attempted to discern, based on section 10(b)’s underlying purposes, whether Congress desired to invoke the resources of U.S. courts in the transnational context.

With these considerations in mind, federal appellate courts, most notably the Second Circuit, developed what became known as the “conduct” and “effects” test. The conduct analysis inquired “whether the wrongful conduct occurred in the United States.” The analysis applied to investors harmed abroad and varied depending on whether the investor was an American or a foreigner. When U.S. investors suffered losses abroad, the Second Circuit required that materially important acts performed in the United States “signifi-
cantly contributed” to the harm. When foreigners suffered losses abroad, however, the acts occurring in the United States must have “directly caused” the harm. In the latter instance, acts in the United States that were “merely preparatory” did not satisfy the conduct test. The Fifth, Seventh, and D.C. Circuits adhered to the Second Circuit’s approach, while the Third, Eighth, and Ninth Circuits embraced more relaxed standards.

The effects analysis, on the other hand, asked “whether the wrongful conduct had a substantial effect in the United States.” The Second Circuit created the effects test based on the belief that Congress intended to protect U.S. investors who acquired foreign securities in U.S. markets and to protect U.S. markets from improper foreign conduct affecting U.S. securities. For instance, in Schoenbaum v. Firstbrook, a case involving securities of a Canadian corporation, the Second Circuit exercised jurisdiction where the transactions at issue had occurred in Canada but impacted the value of common shares trading on a U.S. exchange. The court asserted that application of section 10(b) was “necessary to protect American investors.”

10. Id. at 992-93. For instance, in Bersch, the court concluded that jurisdiction existed where a prospectus emanating from the United States led to a fraudulent offering to U.S. investors abroad. Id. at 992.
11. Id.; see, e.g., Psimenos v. E.F. Hutton & Co., Inc., 722 F.2d 1041, 1047-48 (2d Cir. 1983) (finding direct causation where the alleged fraud was completed through trades on U.S. commodities exchanges).
12. Bersch, 519 F.2d at 992 (noting that “while merely preparatory activities in the United States are not enough to trigger application of the securities laws for injury to foreigners located abroad, they are sufficient when the injury is to Americans so resident”).
13. Robinson v. TCI/US West Commc’ns Inc., 117 F.3d 900, 906 (5th Cir. 1997) (referring to the presumption against extraterritoriality and stating that policy arguments may provide reason for Congress, but not the courts, to expand federal jurisdiction).
14. Kauthar SDN BHD v. Sternberg, 149 F.3d 659, 667 (7th Cir. 1998) (stating that the Second Circuit test provides an appropriate balance between the caution that should be exercised in finding extraterritorial application and the concern that the United States is not used as a base for fraudulent operations).
16. SEC v. Kasner, 548 F.2d 109, 114 (3d Cir. 1977) (asking whether “at least some activity designed to further a fraudulent scheme occurs within this country”).
17. Cont’l Grain (Austl.) Pty., Ltd. v. Pac. Oilseeds, Inc., 592 F.2d 409, 421 (8th Cir. 1979) (inquiring whether “defendants’ conduct in the United States was in furtherance of a fraudulent scheme and was significant with respect to its accomplishment”).
19. Morrison v. Nat’l Austral. Bank Ltd., 547 F.3d 167, 171 (2d Cir. 2008). See also Robinson v. TCI/US West Commc’ns Inc., 117 F.3d 900, 905 (5th Cir. 1997); Zoelsch v. Arthur Anderson & Co., 824 F.2d 27, 30 (D.C. Cir. 1987). The Seventh and Eighth Circuits considered whether the effects were foreseeable and substantial. See Kauthar, 149 F.3d at 665; Cont’l Grain, 592 F.2d at 416.
20. Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (2d Cir. 1968) (rejecting the district court’s conclusion that the Exchange Act did not apply to transactions outside of the territorial United States).
21. 405 F.2d 200 (2d Cir. 1968).
22. Id. at 208-09 (explaining that fraud upon the foreign corporation reduced its equity and resulted in decreased stock value on U.S. exchanges).
23. Id. at 206.
For over forty years, the conduct and effects test was applied and refined by the lower federal courts. Not surprisingly, some commentators criticized the unpredictable and inconsistent application of section 10(b) under the test. In 2010, in *Morrison v. National Australia Bank Ltd.*, the Supreme Court altered the course of federal securities law concerning transnational securities fraud.

**B. The Storm Strikes—The Morrison Decision**

*Morrison* was a “foreign-cubed” case—or rather—a case where foreign investors sued a foreign issuer under U.S. securities laws for securities transactions on a foreign exchange. In 1998, National Australia Bank Ltd. (National Australia) purchased HomeSide Lending, Inc. (HomeSide), a Florida-based mortgage servicing company that received fees for collecting mortgage payments. Because HomeSide would not receive fees once a mortgage was fully paid, the value of HomeSide’s right to receive such fees diminished as mortgages were paid off early. Three years later, National Australia had to write down the value of HomeSide’s assets by $1.2 billion. National Australia explained that it had not anticipated the lowering interest rates and related refinancings. The price of National Australia’s ordinary shares, which were listed on the Australian Stock Exchange Limited (ASX), and its American Depositary Receipts (ADRs), which were listed on the New York Stock Exchange (NYSE), subsequently fell. Australian and American investors then sued National Australia, HomeSide, and their insiders, alleging violations of section 10(b). The plaintiffs claimed that the HomeSide defendants had manipulated the rates of early repayment as “unrealistically low” with the objective of inflating the


27. Id. at 2894 n.11 (Stevens, J., concurring in judgment).

28. As stated by the Third Circuit:

An ADR is a receipt that is issued by a depositary bank that represents a specified amount of a foreign security that has been deposited with a foreign branch or agent of the depositary, known as the custodian. The holder of an ADR is not the title owner of the underlying shares; the title owner of the underlying shares is either the depositary, the custodian, or their agent. ADRs are tradeable in the same manner as any other registered American security, may be listed on any of the major exchanges in the United States or traded over the counter, and are subject to the Securities Act and the Exchange Act. This makes trading an ADR simpler and more secure for American investors than trading in the underlying security in the foreign market.


ostensible value of the mortgage-servicing rights and that the National Australia defendants were aware of this deception.\textsuperscript{30}

The district court dismissed the claims by the American investor in National Australia’s ADRs for failure to allege damages.\textsuperscript{31} Because the American investor did not appeal, only claims by the Australian investors in National Australia’s ordinary shares traded on the ASX were further considered.\textsuperscript{32} The district court then granted defendants’ motion to dismiss for lack of subject-matter jurisdiction, reasoning that the acts in the United States were, “at most, a link in the chain of an alleged overall securities fraud scheme that culminated abroad.”\textsuperscript{33} The Court of Appeals for the Second Circuit affirmed, stating that the domestic acts did not “comprise[e] the heart of the alleged fraud.”\textsuperscript{34} The Supreme Court granted certiorari.\textsuperscript{35}

As a threshold matter, the Court held that the extraterritorial reach of section 10(b) with regard to National Australia’s conduct was a “merits” question under Federal Rule of Civil Procedure (FRCP) 12(b)(6), not a subject-matter jurisdiction question under FRCP 12(b)(1).\textsuperscript{36} This “merits”-based approach constitutes a radical departure from the subject-matter jurisdiction rationale that had been overwhelmingly embraced by the lower federal courts.\textsuperscript{37} Perhaps equally as significant, the Supreme Court rejected the conduct and effects test.\textsuperscript{38}

In determining whether the plaintiffs had stated a claim, the Supreme Court emphasized that unless Congress clearly expresses its affirmative intention “to give a statute extraterritorial effect,” then the statute has no such application.\textsuperscript{39} The Court asserted that lower courts had disregarded this presumption against extraterritoriality by creating the conduct and effects test to “discern” whether Congress would have wanted a statute to apply.\textsuperscript{40} The Court explained the difficulties of applying the conduct and effects test, such as having to decipher the degree of activity that transpired in the United States.\textsuperscript{41} After criticizing the unpredictable application of section 10(b) to transnational cases under the

\textsuperscript{30.} Id.


\textsuperscript{32.} See Morrison, 130 S. Ct. at 2876 n.1.


\textsuperscript{34.} Morrison v. Nat’l Austl. Bank Ltd., 547 F.3d 167, 171 (2d Cir. 2008)


\textsuperscript{36.} Morrison, 130 S. Ct. at 2876-77.

\textsuperscript{37.} See Jared L. Kopel et al., \textit{Current Topics on Securities Litigation, in 1850 Practicing L. Inst., Corp. L. & Prac. Course Handbook Series 365, 391 (2010) (noting that “the Court swiftly swept away a half-century of lower courts treating the issue of extraterritorial reach of the securities law as a question of subject matter jurisdiction”). See, e.g., Morrison, 547 F.3d at 171; Robinson v. TCI/US West Comm’ns Inc., 117 F.3d 900, 906 (5th Cir. 1997); Kauthar SDN BHD v. Sternberg, 149 F.3d 659, 667 (7th Cir. 1998). For further discussion, see infra notes 65-109 and accompanying text.

\textsuperscript{38.} Morrison, 130 S. Ct. at 2877-83.

\textsuperscript{39.} Id. at 2877 (commenting that various courts had been using this approach for decades).

\textsuperscript{40.} Id. at 2878.

\textsuperscript{41.} Id. at 2879. See, e.g., Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 985 (2d Cir. 1975) (distinguishing between U.S. and foreign investors); IIT v. Vencap, Ltd., 519 F.2d 1001, 1018 (2d Cir. 1975) (stating that “mere preparatory activities” do not warrant extraterritorial application).
conduct and effects test, the Court reasoned that applying the presumption against extraterritoriality in all cases provides stability moving forward.\textsuperscript{42}

Next, the Supreme Court considered whether Congress had legislated that section 10(b) applies abroad.\textsuperscript{43} The Court held that the “general reference to foreign commerce in the definition of ‘interstate commerce’ does not defeat the presumption against extraterritoriality.”\textsuperscript{44} Congress’s observations, when setting forth the purposes of the Exchange Act, that “transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest” and that the “prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries” also failed to overcome the presumption.\textsuperscript{45} Lastly, the Solicitor General argued that section 30(b) of the Exchange Act—which specifically authorizes the Securities and Exchange Commission (SEC) to promulgate regulations having extraterritorial application “to prevent . . . evasion of the Exchange Act”—is evidence that the whole Exchange Act applies extraterritorially.\textsuperscript{46} Disagreeing, the Court concluded that section 30(b) appeared to be “directed at actions abroad that might conceal a domestic violation.”\textsuperscript{47}

As an example of “a clear statement of extraterritorial effect,” the Court focused on section 30(a) of the Exchange Act.\textsuperscript{48} That statute provides:

> It shall be unlawful for any broker or dealer . . . to make use of the mails or of any means or instrumentality of interstate commerce for the purpose of effecting on an exchange not within or subject to the jurisdiction of the United States, any transaction in any security the issuer of which is a resident of, or is organized under the laws of, or has its principal place of business in, a place within or subject to the jurisdiction of the United States, in contravention of such rules and regulations as the Commission may prescribe.\textsuperscript{49}

The Court noted that even where a statute, such as section 30(a), has some “extraterritorial application, the presumption against extraterritoriality operates to limit that provision

\textsuperscript{42} See \textit{Morrison}, 130 S. Ct. at 2881 (criticizing “judicial-speculation-made-law” applying U.S. extraterritorially). The Court also specifically disapproved of \textit{Leasco} and \textit{Schoenbaum}—the cases from which the Second Circuit developed its conduct and effects test. \textit{Id.} at 2887. \textit{Leasco Data Processing Equip. Corp. v. Maxwell}, 468 F.2d 1326 (2d Cir. 1972); \textit{Schoenbaum v. Firstbrook}, 405 F.2d 200 (2d Cir. 1968).

\textsuperscript{43} \textit{Id.} at 2882-83.

\textsuperscript{44} \textit{Id.} at 2882 (discussing the definition of “interstate commerce” in the Exchange Act, 15 U.S.C. §78c(a)(17) (2010)).

\textsuperscript{45} \textit{Id.} (quoting 15 U.S.C. § 78b).

\textsuperscript{46} Brief for the United States as Amicus Curiae Supporting Respondent at 14, \textit{Morrison}, 130 S. Ct. 2869 (No. 08-1191), 2010 WL 719337 (contending that “[this] exemption would have no function if the Act did not apply in the first instance to securities transactions that occur abroad”).

\textsuperscript{47} \textit{Morrison}, 130 S. Ct. at 2882-83.

\textsuperscript{48} \textit{Id.} at 2883. The Court remarked that this provision providing for “a specific extraterritorial application would be quite superfluous if the rest of the Exchange Act already applied to transactions on foreign exchanges.” \textit{Id.}

The Court concluded that there was not a sufficient basis to overcome the presumption against extraterritoriality for section 10(b). Alternatively, the plaintiffs argued that the extraterritorial reach of section 10(b) was immaterial in this instance because they only sought domestic application concerning the alleged financial manipulations and public statements of HomeSide that occurred in Florida. In response, the Court commented:

"It is a rare case of prohibited extraterritorial application that lacks all contact with the territory of the United States. But the presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever some domestic activity is involved in the case."

The Court thus reasoned that the Exchange Act focuses on purchases and sales of securities in the United States, not on the location where the deception occurs. If indeed Congress had intended for the Exchange Act to apply to conduct affecting transactions consummated abroad, the Court stated that "it would have addressed the subject of conflicts with foreign laws and procedures."

The Court thereupon enunciated the "transactional test" for the invocation of section 10(b). Under this test, for section 10(b) to apply, "the purchase or sale [must be] made in the United States, or [must involve] a security listed on a domestic exchange."

Note that in certain circumstances, the SEC may be able to institute suit under section 17(a) of the Securities Act when there are illegal offers to sell in the United States. Because section 17(a) extends to both offers and sales, a domestic offer (even when the transaction is consummated abroad) comes within section 17(a)'s coverage. See SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147, 165 (S.D.N.Y. 2011). Significantly, section 17(a) is solely a government enforcement tool. There is no private right of action under that statute. See, e.g., Finkel v. Stratton Corp., 962 F. 2d 169 (2d Cir. 1992); Sears v. Likens, 912 F. 2d 889 (7th Cir. 1990); Landry v. All Am. Assurance Co., 688 F. 2d 381 (5th Cir. 1982). For analyses of section 17(a), see Aaron v. SEC, 446 U.S. 680 (1980); United States v. Naftalin, 441 U.S. 768 (1979); Marc I. Steinberg, Section 17(a) of the Securities Act After Naftalin and Redington, 68 Geo. L.J. 163 (1979).
cause the plaintiffs in *Morrison* did not purchase or sell securities listed on a domestic exchange, and because the transactions at issue did not otherwise occur in the United States, the Court concluded that the plaintiffs had failed to state a claim and accordingly affirmed dismissal under FRCP 12(b)(6).

Overall, *Morrison* contains three significant holdings: the abrupt characterization of extraterritoriality as a merits question; the determination that section 10(b) does not overcome the presumption against extraterritoriality (with the related rejection of the conduct and effects test); and the creation of the transactional test. Before the impact of these holdings is examined, however, this article addresses Congress’s response to the limitations pronounced in *Morrison*.

C. A PRESCRIPTION FOR THE STORM—THE SEC-DOJ DODD-FRANK AMENDMENT

One day after the Court released its *Morrison* decision, Congress enacted section 929P of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) authorizing extraterritorial jurisdiction under the Exchange Act for actions brought by the SEC and the U.S. government, such as the Department of Justice (DOJ). Specifically, the statute provides:

(c) Extraterritorial Jurisdiction.—The district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or the United States alleging a violation of [the antifraud provisions of this title] involving—

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58. *Morrison*, 130 S. Ct. at 2888. Justice Stevens, joined by Justice Ginsburg, concurred in the judgment only. See id. at 2888-95 (Stevens, J., concurring in judgment). Justice Stevens stated that the judge-made rules in U.S. securities law were invited by Congress when it deliberately created, and subsequently left intact, an open-ended statute. Id. at 2889-90. He contended that Second Circuit case law had been thoughtfully developed over several decades, had gained the “tacit approval of Congress and the Commission,” and, thus, ought to be favored by the Court. Id. at 2890-91. Justice Stevens criticized Justice Scalia for limiting his search for an indication of extraterritorial application to statutory text. Id. at 2891-92 (explaining that “all available evidence about the meaning” of a provision should be considered to effectuate Congress’s will regarding extraterritorial application). In any case, Justice Stevens argued that it was not appropriate to discard the conduct and effects test based on the presumption against extraterritoriality because the test turns on the presence of sufficient domestic contacts in transnational securities fraud, not the complete absence of domestic contacts. Id. at 2892. Justice Stevens found that the statutory text in section 10(b) and section 30(a) and (b)—which the majority held had no clear indication of extraterritorial application—offered strong indication that the Act covers at least some transnational frauds. Id. at 2893-94 n.9. Justice Stevens then stated that the real problem with the majority’s opinion is that its test for domestic application is based on the belief that transactions on domestic exchanges, rather than the interests of the public and investors, are the focus of the Exchange Act. Id. at 2894 (quoting Eur. & Overseas Commodity Traders, S.A. v. Banque Paribas London, 147 F.3d 118, 125 (2d. Cir. 1998)). He pointed out that the transactional test created by the majority would leave an unsophisticated U.S. retiree who bought shares on a foreign exchange without a section 10(b) remedy even if, on the basis of material misrepresentations, the purchase was induced in the United States by a U.S. subsidiary of the issuer. Id. at 2895. With regard to the facts in *Morrison* though, Justice Stevens concluded, “this case has Australia written all over it.” Id.; see generally Genevieve Beyea, *Morrison* v. National Australia Bank and the Future of Extraterritorial Application of the U.S. Securities Laws, 72 Ohio St. L.J. 537 (2011); Elizabeth Cowenz, *Paradise Lost*: § 10(b) After *Morrison* v. National Australia Bank, 11 Chi. J. Int’l L. 343 (2011).

(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
(2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

According to floor comments made by the statute’s sponsor, Representative Paul Kanjorski, section 929P sought to nullify the presumption against extraterritoriality of the antifraud provisions of the U.S. securities laws with regard to government-brought actions by codifying the conduct and effects test repudiated by Morrison. Additionally, the Dodd-Frank Act mandated that the SEC perform a study and report to Congress within eighteen months on whether the test set forth in section 929P should be extended to private actions.

Congress therefore wrote a prescription to cure the ills of Morrison in the government enforcement setting. Whether Congress in fact prescribed the proper medicine is uncertain. In Morrison, the Supreme Court held that extraterritorial application was a matter of substantive law, not subject-matter jurisdiction. Ignoring this rationale, Congress framed section 929P in terms of jurisdiction. Thus, it remains to be seen whether Congress’s efforts regarding SEC and DOJ actions will be effective.

Section 929P is discussed further in the next section, which examines the consequences of treating extraterritoriality as a merits question and the implications of the abrupt departure from the historical treatment of this subject.

III. Divergent Waves—Subject-Matter Jurisdiction and the Merits

Extraterritoriality has traditionally been dealt with as a matter of subject-matter jurisdiction. However, held that this approach was not appropriate with regard to

60. Id.
63. Morrison, 130 S. Ct. at 2877.
The Court explained that to inquire about extraterritorial reach is really to ask what conduct is prohibited under section 10(b), which goes to the merits of the claim. It stated that subject-matter jurisdiction, on the other hand, concerns a court’s “power to hear a case.” The differences between a jurisdictional and a merits challenge are discussed below, followed by an exploration of the implications of this change beyond section 10(b).

A. Assessing the Storm—Consequences of Jurisdictional and Merit-Based Characterizations

Classifying an issue as jurisdictional or merit-based can impact when a challenge may be brought, who resolves the challenge, and the finality of the resolution. For example, a motion based on subject-matter jurisdiction may be raised at any time, whereas a challenge based on the merits is forfeited if not brought to the court in a timely manner. An instance where this timing may affect the outcome of a case is where a defendant raises an issue for the first time on appeal. Such a challenge will likely be rejected as untimely if the court determines that the issue is based on the merits, rather than that of subject-matter jurisdiction.

Additionally, courts have an independent obligation to determine that subject-matter jurisdiction exists but have no such obligation regarding merit requirements. Thus, a court must inquire into such jurisdictional issues on its own accord. Characterization of an issue as jurisdictional or merit-based also influences whether a judge or a jury will resolve the dispute. Particularly, a judge may weigh evidence concerning contested facts

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66. See Morrison, 130 S. Ct. at 2877.
67. Id.
68. Id. One commentator defined the difference saying, “Merits ask whether the defendant’s conduct was legally constrained (by the Constitution or by act of Congress); jurisdiction asks whether a federal court has the power to enforce that legal constraint on the defendant’s conduct.” Howard M. Wasserman, Jurisdiction and Merits, 80 WASH. L. REV. 643, 671-72 (2005).
70. Id. at 514.
71. Union Pac. R.R. Co. v. Bhd. of Locomotive Eng’rs, 130 S. Ct. 584, 596 (2009) (stating that a “claim-processing rule . . . is ordinarily forfeited if the party asserting the rule waits too long to raise the point”).
72. See, e.g., Arbaugh v. Y & H Corp., 380 F.3d 219, 230-31 (5th Cir. 2004) (affirming the district court’s decision to vacate a jury verdict for the plaintiff where the defendant raised an issue of subject matter jurisdiction for the first time after the trial), rev’d, 546 U.S. 500 (2006).
73. See, e.g., Arbaugh, 546 U.S. at 504 (rejecting a challenge based on the merits of a claim because the defendant had failed to raise the issue before the close of trial).
74. Id. at 514; compare Fed. R. Civ. P. 12(h)(3) (stating that “[i]f the court determines at any time that it lacks subject-matter jurisdiction, the court must dismiss the action”), with Fed. R. Civ. P. 12(b)(2) (stating that a “[f]ailure to state a claim upon which relief can be granted . . . may be raised: (A) in any pleading allowed or ordered under Rule 7(a); (B) by a motion under Rule 12(c); or (C) at trial”). In determining that the ERISA requirement that an employer has fifteen or more employees was a merits rather than jurisdiction issue, the Supreme Court noted that the text of ERISA did not indicate that “Congress intended courts, on their own motion, to assure that the employee-numerosity requirement is met.” Arbaugh, 546 U.S. at 514.
75. See Arbaugh, 546 U.S. at 514 (referring to Charles Wright & Arthur Miller, 5B FEDERAL PRACTICE & PROCEDURE § 1350 (3d ed. 2004)).
to resolve a dispute concerning subject-matter jurisdiction, whereas a jury is the trier of contested facts when an element of the claim is at issue.\textsuperscript{76}

The finality of a resolution may also depend on characterization of an issue as jurisdictional or merit-based. A dismissal due to lack of subject-matter jurisdiction typically is without prejudice, allowing a plaintiff to bring the claim in an appropriate court.\textsuperscript{77} But if a claim is dismissed on the merits, the plaintiff would be precluded from arguing for a different outcome elsewhere.\textsuperscript{78} Furthermore, the court’s characterization of the issue may affect other claims. An appellate court must dismiss the entire complaint if subject-matter jurisdiction is found lacking.\textsuperscript{79} A motion to dismiss for failure to state a claim, on the other hand, allows the court discretion to exercise supplemental jurisdiction over pendant issues.\textsuperscript{80}

These differences can potentially impact the outcome of litigation. With the exception of potential claim preclusion, the characterization of an issue as merit-based appears to favor plaintiffs. When an issue is deemed a merits question there is a limited time for challenges by defendants, no independent judicial obligation to ensure that merit requirements are met, and a jury to resolve disputes concerning contested facts. It should be noted, however, that a pretrial dismissal usually does not depend on characterization of an issue as jurisdictional or merit-based, as evidenced in \textit{Morrison}.

National Australia raised the issue of extraterritorial reach of section 10(b) before trial and therefore had not forfeited a challenge based on the merits. The Court found it unnecessary to remand the case based on the Second Circuit’s dismissal of the case for lack of jurisdiction under FRCP 12(b)(1), instead of dismissal for failure to state a claim under FRCP 12(b)(6), reasoning that the new labeling would result in the same outcome.

In \textit{Morrison}, the Supreme Court abruptly overruled decades of history treating section 10(b) extraterritoriality as an issue of subject-matter jurisdiction. The impact of this change on extraterritorial securities litigation under section 10(b) is monumental. As discussed next, \textit{Morrison} is already influencing the characterization of statutory requirements of other federal statutes.

\textsuperscript{76} See id.
\textsuperscript{77} \textit{Restatement (Second) of Judgments} § 26(1) (2011) (providing an exception to claim preclusion where “[t]he plaintiff was unable to rely on a certain theory of the case or to seek a certain remedy or form of relief in the first action because of the limitations on the subject matter jurisdiction of the courts”).
\textsuperscript{78} See Allen v. McCurry, 449 U.S. 90, 94 (1980) (noting that “a final judgment on the merits of an action precludes the parties or their privies from relitigating issues that were or could have been raised in that action”).
\textsuperscript{79} \textit{Arbaugh}, 546 U.S. at 514 (citing J. Moore et al., 15 Moore’s Federal Practice § 106.66[1] (3d ed. 2005)).
\textsuperscript{80} Id. (explaining that this discretion stems from 28 U.S.C. § 1367).
\textsuperscript{81} See \textit{Morrison v. Nat’l Austl. Bank Ltd.}, 130 S. Ct. 2869, 2877 (2010) (reasoning that “[s]ince nothing in the analysis of the courts below turned on the mistake, a remand would only require a new Rule 12(b)(6) label for the same Rule 12(b)(1) conclusion”). See also \textit{ABF Freight Sys., Inc. v. Int’l Bhd. of Teamsters}, 645 F.3d 954, 965 (8th Cir. 2011) (stating that “[i]t is true that an appellate court may treat a Rule 12(b)(1) issue as a Rule 12(b)(6) issue”); \textit{Daniels-Hall v. Nat’l Educ. Ass’n}, 629 F.3d 992, 997-98 (9th Cir. 2010) (finding that remand was unnecessary where the district court incorrectly discussed an ERISA matter for lack of subject matter jurisdiction, rather than failure to state a claim).
\textsuperscript{82} See, e.g., \textit{Morrison}, 130 S. Ct. at 2877 (citing \textit{Romero v. Int’l Terminal Operating Co.}, 358 U.S. 354, 359, 381-84 (1959)).
B. RIDING THE WAVES—IMPLICATIONS BEYOND SECTION 10(b)

The jurisdiction provision for the Exchange Act states:

The district courts of the United States . . . shall have exclusive jurisdiction of violations of [the Exchange Act] or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder . . . .

There is thus no mention of extraterritoriality or any requirements regarding the scope of section 10(b) in the foregoing statute. In *Morrison*, the Court stated that to establish subject-matter jurisdiction, a plaintiff need only allege a violation of the Exchange Act. Other federal statutes with similarly worded jurisdictional provisions would be expected to yield results identical to *Morrison* in the future—that is, characterization of an issue regarding the statute’s scope as a merits question.

Before *Morrison*, several circuit courts treated the requirements of the Foreign Trade Antitrust Improvement Act (FTAIA), which limits the extraterritorial reach of the Sherman Act, as a jurisdictional issue. The Seventh Circuit noted that for six decades before the enactment of the FTAIA, courts had treated application of the Sherman Act with regard to foreign markets as a matter of subject-matter jurisdiction and that legislation should “be read to conform with Supreme Court precedent.” Extraterritorial reach of the Sherman Act, without regard to the FTAIA, has also been characterized as a matter of subject-matter jurisdiction. Justice Scalia strongly dissented to this characterization in *Hartford Fire Insurance Company v. California*, insisting that, “the extraterritorial reach of the Sherman Act . . . has nothing to do with the jurisdiction of the courts. It is a question of substantive law turning on whether, in enacting the Sherman Act, Congress asserted regulatory power over the challenged conduct.” After *Morrison*, Justice Scalia’s approach may well emerge victorious.

Extraterritoriality is not the first issue to generate confusion over whether a decision based on jurisdiction or the merits is appropriate. Until the Supreme Court resolved the

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84. See *Morrison*, 130 S. Ct. at 2877 (citing 15 U.S.C. § 78aa in finding that the District Court had jurisdiction to determine whether section 10(b) applied to National Australia’s conduct).
85. See, e.g., 42 U.S.C. § 2000e-5(f)(3) (2011) (Title VII) (“Each United States district court and each United States court of a place subject to the jurisdiction of the United States shall have jurisdiction of actions brought under this subchapter.”).
86. See, e.g., United States v. LSL Biotechnologies, 379 F.3d 672, 679 (9th Cir. 2004); United Phosphorus Ltd. v. Angus Chem. Co., 322 F.3d 942, 952 (7th Cir. 2003) (en banc); Den Norske Stats Oljeselskap A/S v. HeereMac Vof, 241 F.3d 420, 425 (5th Cir. 2001). Dissenting in *United Phosphorus Ltd.*, Judge Diane Wood argued that the FTAIA language that the Sherman Act “shall not apply” to certain foreign conduct did not speak to the court’s power to consider the case. 322 F.3d at 954-55 (Wood, J., dissenting).
87. *United Phosphorus Ltd.*, 322 F.3d at 951.
89. Id. at 813 (Scalia, J., dissenting).
90. Indeed, the Seventh Circuit recently overruled its own precedent in determining that the FTAIA is a merits-based limitation, rather than a jurisdictional one. *Minn-Chem, Inc. v. Agruim, Inc.*, 683 F.3d 845, 848 (7th Cir. 2012) (en banc) (overruling *United Phosphorus Ltd.*, 322 F.3d at 942). The Third Circuit has also since held that the FTAIA goes to the scope of an antitrust claim. *Animal Sci. Prods., Inc. v. China Minmetals Corp.*, 654 F.3d 462, 466-69 (3d Cir. 2011) (discussing *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869 (2010), and *Arbaugh v. Y & H Corp.*, 546 U.S. 500 (2006)).
issue in *Arbaugh v. Y & H Corp.*, there was a deep circuit split regarding whether the definition of an employer under Title VII of the Civil Rights Act of 1964 was a jurisdictional or a merits issue. The Fifth Circuit in *Arbaugh* held that fifteen or more employees were necessary to establish subject-matter jurisdiction of a Title VII claim. The Supreme Court rejected this characterization and stated that the requirement was a merits question. Additionally, since *Morrison*, it has been contended that certain requirements under other statutes, such as ERISA and the Alien Tort Statute (ATS), should be characterized as merits questions.

All this is not to say that an issue that goes to the scope of the conduct covered under the statute can never be a jurisdictional issue. The Supreme Court has stated that Congress has the power to make a threshold limitation on a statute’s scope jurisdictional by clearly identifying it as such. To determine whether Congress has exercised this power, the Court has focused on whether the threshold appears in the jurisdictional provision of the statute or if it is accompanied by any jurisdictional language. For example, the amount-in-controversy threshold for diversity-of-citizenship jurisdiction under 28 U.S.C. § 1332 is an example of a requirement deemed jurisdictional by Congress. By contrast, in *Union Pacific Railroad Co. v. Brotherhood of Locomotive Engineers*, the Supreme Court held that a conferencing requirement under the Railway Labor Act (RLA) was not jurisdictional because it was “not moored” to the section of the RLA establishing jurisdiction.

Had the conduct and effects test not been rejected in *Morrison* for substantive reasons, the Dodd-Frank amendment arguably would have been successful in converting the test into a jurisdictional requirement for cases brought by the SEC and DOJ. Notably, section 929P speaks extensively in jurisdictional language. But in light of the substantive limitations set forth in *Morrison*, it may well be that the amendment futilely attempts to grant jurisdiction beyond the substantive reach of the Exchange Act.

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92. Wasserman, supra note 68, at 657 n.65 (2005) (listing cases from eight different circuit courts over the past three decades).
94. *Arbaugh*, 546 U.S. at 516. Because the plaintiff moved for dismissal based on subject-matter jurisdiction for the first time on appeal, characterization of the issue as a merits question resulted in reinstatement of the jury’s decision against the plaintiff because there was not a timely motion to dismiss on the merits. See *Arbaugh v. Y & H Corp.*, 446 F.3d 573, 573-74 (5th Cir. 2006).
95. Daniels-Hall v. Nat’l Educ. Ass’n, 629 F.3d 992, 997-98 (9th Cir. 2010) (regarding whether an employment plan was subject to ERISA).
99. *Arbaugh*, 546 U.S. at 514-15. *See also* 28 U.S.C. § 1332(a) (“The district courts shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum or value of $75,000.”).
100. 130 S. Ct. 584 (2009).
101. Id. at 597-99 (commenting that the two provisions were in separate sections).
102. See supra notes 59-64 and accompanying text.
103. See, e.g., Painter et al., supra note 64, at 4.
A similar argument was made with regard to the Alien Tort Statute (ATS)\textsuperscript{104} in\textit{ Sosa v. Alvarez-Machain}.\textsuperscript{105} The defendant argued that the ATS was “stillborn” because the jurisdictional grant did not have a corresponding cause of action.\textsuperscript{106} The Supreme Court held that federal common law at the time the ATS was passed in 1789 provided substantive law to support the jurisdictional grant.\textsuperscript{107} In its decision, the Court considered evidence that Congress intended the statute to have immediate effect upon enactment.\textsuperscript{108}

While\textit{ Morrison} clearly finds substantive law lacking for the conduct and effect test, courts may draw from\textit{ Sosa} and proceed based on Congress’s intent to overrule\textit{ Morrison}, taking into account the brief period in which Congress had to respond to\textit{ Morrison} and the lengthy history of courts treating extraterritorial application as a matter of jurisdiction. Given the uncertainty surrounding section 929P though, Congress (at least in the government enforcement context) should expand the substantive reach of section 10(b) to help ensure that the law is interpreted as Congress intended.\textsuperscript{109}

Overall, a significant impact of the\textit{ Morrison} declaration that section 10(b) extraterritoriality is a merits question is with respect to the characterization of the statutory requirements of other statutes. Future characterization of extraterritoriality appears particularly susceptible to the reasoning in\textit{ Morrison}, though Congress’s ability to make a requirement jurisdictional means that courts cannot assume that a merits question under one statute is necessarily a merits question under another statute. As for the future of the Dodd-Frank amendment, the potential problems seem to lie in the substantive limitations of the Exchange Act, not with Congress’s jurisdictional characterization of extraterritoriality. The impact of\textit{ Morrison}’s extraterritoriality analysis on other federal law is examined next.

IV. Wave Impact—Extraterritoriality with Regard to Other Federal Law

In\textit{ Morrison}, the Supreme Court stated that the presumption against extraterritoriality is a canon of construction that applies generally to the legislation of Congress.\textsuperscript{110} The Court explained that this presumption rests on the perception that Congress usually legislates with regard to domestic, rather than foreign, concerns.\textsuperscript{111} Thus, unless Congress clearly indicates that a statute has extraterritorial reach, courts should presume the statute does not apply abroad.\textsuperscript{112} While\textit{ Morrison} is not the first Supreme Court case to support that general concept,\textsuperscript{113} its outcome may unleash a new wave of defendants challenging

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104. 28 U.S.C. § 1350 (2011). In its entirety, the ATS states: “The district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States.” Id.
106. Id. at 714.
107. Id. at 724.
108. Id.
109. Interestingly, the SEC has not relied on the Dodd-Frank amendment in post-\textit{Morrison} cases. See SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147 (S.D.N.Y. 2011); SEC v. Credit Bancorp, Ltd., 738 F. Supp. 2d 376 (S.D.N.Y. 2010). Because the less strict conduct and effects test should make it easier for the SEC to bring section 10(b) actions, perhaps the SEC harbors doubts about its effectiveness.
111. Id.
112. Id. at 2878.
113. See, e.g., Foley Bros. v. Filardo, 336 U.S. 281, 285 (1949) (“[L]egislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.”); see also Smith
the extraterritorial application of federal statutes. To gain an understanding of how _Morrison_ might impact other federal law, this section examines the Racketeer Influenced and Corrupt Organization Act (RICO), a statute whose extraterritoriality is unsettled, and the Lanham Act, a statute whose extraterritorial application was reinforced by _Morrison_.114

A. ROGUE WAVE—RICO

Prior to _Morrison_, several circuit courts adopted the conduct and effects test to determine the extraterritorial application of RICO.115 For example, the Ninth Circuit, upon finding that RICO is silent as to extraterritorial application, reasoned that the securities laws’ conduct and effects test was useful in determining RICO’s extraterritorial application.116 The Eleventh Circuit, after rejecting the assertion that RICO does not apply extraterritorially without an explicit statement to that effect, also adopted the conduct and effects test.117 In _United States v. Philip Morris USA Inc._,118 the District of Columbia Circuit applied the effects test in determining that RICO applied where a British tobacco company was accused of deceiving U.S. consumers about the risks of smoking cigarettes.119 But unlike the Ninth and Eleventh Circuits, the D.C. Circuit held that regulation of foreign conduct in such cases did not involve extraterritorial application, as the United States has a “legitimate interest in protecting its citizens within its borders.”120 The court stated that the presumption against extraterritoriality did not apply when a statute meets the effects test; rather, RICO would only have “true” extraterritorial reach if it were able to reach “foreign conduct with no impact on the United States.”121

These pre- _Morrison_ analyses likely do not hold up today. In _Morrison_, the Supreme Court explained that the conduct and effects test stemmed from courts’ misguided attempts to discern whether Congress would have wanted to apply section 10(b) even though the statute was silent as to extraterritorial application.122 Without clear statutory

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114. These two statutes were chosen for discussion because each had case law discussing extraterritoriality prior to _Morrison_. Additionally, an analysis of RICO and the Lanham Act allows for comparison of a statute that likely does not overcome the presumption against extraterritoriality with one that does. For some of the other statutes whose extraterritoriality has been examined after _Morrison_, see _Sarei v. Rio Tinto_, PLC, 671 F.3d 736, 744 (9th Cir. 2011) (Alien Tort Statute); _YonRui Group Co. v. International Trade Commission_, 661 F.3d 1322, 1328-32 (Fed. Cir. 2011) (Tariff Act); _United States v. Elite_, No. S3 10 CRIM. 0336(LAK), 2012 WL 383403, at *2-3 (S.D.N.Y. Feb. 7, 2012) (Internet Gambling Business Act of 1970); _Souryal v. Torres Advanced Enterprise Solutions, LLC_, 847 F. Supp. 2d 835, 841-43 (E.D. Va. 2012) (Family and Medical Leave Act of 1993).

115. See _United States v. Philip Morris USA Inc._, 566 F.3d 1095, 1110-11 (D.C. Cir. 2009); _Liquidation Comm’n of Banco Intercontinental_, S.A. v. _Renta_, 530 F.3d 1319, 1351-52 (11th Cir. 2008); _Poulos v. Caesar World_, Inc., 379 F.3d 654, 663 (9th Cir. 2004). _See also_ _Kauthar SDN BHD v. Sternberg_, 149 F.3d 659, 671-72 (7th Cir. 1998) (opting to save determination on the extraterritorial scope of RICO for another day).

116. _Poulos_, 379 F.3d at 663.

117. _Renta_, 530 F.3d at 1351-52.

118. 566 F.3d 1095 (D.C. Cir. 2009).

119. Id. at 1105-06, 1110-31.

120. Compare id. at 1110, with _Poulos_, 379 F.3d at 663, and _Renta_, 530 F.3d at 1351-52.

121. _Philip Morris_, 566 F.3d at 1130 (emphasis added).

indication that RICO was meant to apply extraterritorially, there is no reason to think that this test would be any more appropriate in a RICO case. Indeed, based on Morrison and the presumption against extraterritoriality, several courts have since concluded that RICO does not apply extraterritorially.\(^{123}\) One district court, for example, specifically rejected the conduct and effects test with regard to RICO “for the same reasons” as in Morrison.\(^{124}\)

The D.C. Circuit’s assertion that the effects test is a test for domestic, rather than extraterritorial, application is an interesting approach to RICO. While that particular test may not survive Morrison, a workable test for domestic application of RICO involving foreign contacts might yet be developed. In Morrison, by creating the transactional test, the Supreme Court prescribed the domestic contacts necessary to establish a section 10(b) claim.

The Court of Appeals for the Second Circuit recently had the opportunity to develop a minimum-domestic-contacts test for RICO claims but declined. In Norex Petroleum Ltd. v. Access Industries, Inc.,\(^ {125}\) Norex Petroleum Ltd. (Norex), a Canadian corporation, alleged that the primarily foreign group of defendants was involved in a widespread racketeering conspiracy aimed at taking over the Russian oil industry.\(^ {126}\) Norex claimed that defendants violated RICO by laundering money and committing other acts in furtherance of this scheme in the United States.\(^ {127}\) The defendants argued that Norex had failed to raise a RICO claim because the principal actions had taken place outside of the United States.\(^ {128}\) The Second Circuit held, based on Morrison, that RICO did not have extraterritorial application.\(^ {129}\) In its analysis, the court stated that Morrison created a “bright-line rule” for determining a statute’s extraterritorial application: “absent a clear Congressional expression of a statute’s extraterritorial application, a statute lacks extraterritorial reach.”\(^ {130}\)

After noting Second Circuit precedent holding that “RICO is silent as to any extraterritorial application,” the court rejected each of Norex’s arguments to the contrary.\(^ {131}\) Particularly, it held that: RICO’s broad language defining commerce\(^ {132}\) did not indicate


\(^{125}\) 631 F.3d 29 (2d Cir. 2010).

\(^{126}\) Id. at 31. The defendants were primarily foreign actors, though several were U.S. citizens or conducted business in the United States. Norex Petroleum Ltd. v. Access Indus., Inc., 304 F. Supp. 2d 570, 572-73 (S.D.N.Y. 2004), vacated, 416 F.3d 146 (2d Cir. 2005).

\(^{127}\) Norex, 631 F.3d at 31. Specifically, Norex asserted that U.S. and foreign banking facilities concealed financial transactions to divert revenues on behalf of defendants. Norex Petroleum, 304 F. Supp. 2d at 573.

\(^{128}\) Norex, 631 F.3d at 32.

\(^{129}\) Id. at 33. The separate mail and wire fraud statutes have extraterritorial application, however, and should be available for criminal cases where a RICO claim is unavailable because RICO does not apply extraterritorially. Kopel et al., supra note 37, at 398.

\(^{130}\) Norex, 631 F.3d at 32 (citing Morrison v. Nat’l Austl. Bank Ltd., 130 S. Ct. 2869, 2877 (2010)).

\(^{131}\) Id. at 32.

\(^{132}\) RICO prohibits the use or investment of racketeering proceeds affecting “interstate or foreign commerce.” 18 U.S.C. § 1962(a) (2011). The statute also prohibits a person from gaining or maintaining, through racketeering activities, an interest in an enterprise affecting “interstate or foreign commerce.” Id. § 1962(b).
extraterritorial application; the extraterritorial reach of RICO’s predicate acts, such as wire fraud, did not extend beyond the terms of those provisions to RICO as a whole; and alleging some occurrence of domestic conduct was not enough to support domestic application of RICO. Concluding that the slim domestic contacts alleged by Norex were not enough to support extraterritorial application of RICO, the court dismissed the claims under FRCP 12(b)(6). The court declined to discuss what domestic contacts would have supported RICO application despite the foreign contacts. Subsequently, as discussed below, a number of district courts have considered this question.

In Morrison, the Supreme Court indicated that any test for domestic application should reflect the focus of the statute prompting several courts to perform a statutory analysis of RICO. According to its statutory language, RICO does not criminalize racketeering activities standing alone—those are criminalized under other statutes—rather, the statute criminalizes racketeering activities in connection with an enterprise. This has led several courts to conclude that the focus of RICO is on the enterprise.

The statute’s purpose, which is stated as “the elimination of the infiltration of organized crime and racketeering into legitimate organizations operating in interstate commerce,” supports this conclusion. The reference to interstate commerce suggests that Congress’s intent was that federal courts should be concerned with specific international controversies.

133. Norex, 631 F.3d at 33. “[W]e have repeatedly held that even statutes that contain broad language in their definitions of commerce do not apply abroad.” Id. (quoting Morrison, 130 S. Ct. at 2882).

134. Id. “[W]hile Section 30(b) of the Exchange Act . . . can be interpreted to apply abroad, the presumption against extraterritoriality operates to limit that provision to its terms.” Id. (quoting Morrison, 130 S. Ct. at 2882-83).

135. Id. “[I]t is a rare case of prohibited extraterritorial application that lacks all contact with the territory of the United States.” Id. (quoting Morrison, 130 S. Ct. at 2884) (emphasis in original).

136. Id. Before the Morrison decision, the Second Circuit would have also engaged in an inquiry of whether Congress “would have intended that federal courts should be concerned with specific international controversies.” See N.S. Fin. Corp. v. Al-Turki, 100 F.3d 1046, 1051 (2d Cir. 1996), overruled by Norex Petroleum Ltd. v. Access Indus., Inc., 631 F.3d 29 (2d Cir. 2010). Though the Second Circuit never settled on a specific test under this inquiry for the extraterritorial application of RICO, it indicated that it might have found a variation of the securities laws’ effects test appropriate. Id. at 1052 (commenting that the effects-oriented approach used in antitrust cases might be preferred in RICO cases as RICO’s substantive law and damages has similarities with parts of the Sherman Act).


138. See Morrison, 130 S. Ct. at 2884 (examining the Exchange Act to identify the focus of congressional concern).

139. See, e.g., Le-Nature’s, 2011 WL 2112533, at *3; Toyota, 785 F. Supp. 2d at 914; European Cmty., 2011 WL 843957, at *5-6; Cedeño, 733 F. Supp. 2d at 472-73.


141. See, e.g., Sorota v. Sosa, 842 F. Supp. 2d 1345, 1350 (S.D. Fla. 2012); Le-Nature’s, 2011 WL 2112533, at *3; Toyota, 785 F. Supp. 2d at 914; European Cmty., 2011 WL 843957, at *5; Cedeño, 733 F. Supp. 2d at 474. To determine the location of the enterprise in a RICO case, some courts have employed the “nerve center” test, which inquires as to where the decision-makers are. See Minui O.S.K. Lines, Ltd. v. Seamaster Logistics, Inc., No. 11-2861 SC, 2012 WL 1667108, *4-5 (N.D. Cal. May 10, 2012); European Cmty., 2011 WL 843957, at *5-6. Not all courts, however, have agreed that the enterprise is the focus of RICO. See, e.g., CGC Holdings Co. v. Hutchens, 824 F. Supp. 2d 1193, 1209 (D. Colo. 2011) (finding that “racketeering activity” is the focus of RICO).

principal concern was focused on the corruption of domestic enterprises. It can be argued that Congress would have addressed possible conflicts with foreign laws and procedures if RICO had been intended to apply to corruption abroad. Thus, U.S. citizens harmed by a foreign enterprise may not have recourse under RICO.

Undoubtedly, Morrison will continue to be mentioned in discussions of statutes like RICO whose extraterritoriality is not yet settled. A conclusion that a statute does not have extraterritorial reach is likely not enough to rule on a claim though, as shown by the creation of the Morrison transactional test for domestic application of section 10(b). Next, an analysis of the Lanham Act reveals similar shortcomings where a statute has been deemed to have extraterritorial reach.

B. SURFING THE WAVES—THE LANHAM ACT

The extraterritorial application of the Lanham Act, which covers trademark infringement and unfair competition claims, was reinforced by Morrison. It may be instructive in predicting the extraterritoriality of other federal laws after Morrison to understand the background supporting this finding of extraterritoriality. Furthermore, it is worth noting the tests that the federal appellate courts have developed limiting extraterritorial application of the Lanham Act.

In 1952, the Supreme Court held that jurisdiction existed in a Lanham Act case where the alleged trademark infringement was consummated outside the United States. In Steele v. Bulova Watch Co., Bulova Watch Co. (Bulova), a New York corporation, sued Steele, a U.S. citizen, for stamping the name “Bulova” on watches that he assembled and sold in Mexico. The Court stated that international law did not prevent the United States from “governing the conduct of its own citizens ... in foreign countries when the rights of other nations or their nationals are not infringed.” Based on the Lanham Act’s “broad jurisdictional grant,” which included “sweeping reach into ‘all commerce which may lawfully be regulated by Congress,’” the Court found legislative intent that the statute’s scope encompassed Steele’s activities abroad. The Court explained that Steele’s “operations

143. Additionally, in the prologue of the Organized Crime Control Act of 1970, the Act through which RICO was enacted, Congress published findings that organized criminal activities in the United States weaken the U.S. economy; “seriously burden interstate and foreign commerce, threaten the domestic security, and undermine the general welfare of the [United States] and its citizens.” Pub. L. No. 91-452, intro., 84 Stat. 922, 923 (emphasis added). In Morrison, the Court referred to the prologue of the Exchange Act as supporting the importance of the domestic exchange in section 10(b). 130 S. Ct. at 2884-85.

144. See Morrison, 130 S. Ct. at 2885 (refusing to find that the Exchange Act reaches foreign exchanges and transactions because Congress would have addressed conflicts with foreign laws and procedures if the statute were intended to apply abroad).

145. This outcome would not be unlike the potential harsh realities of the section 10(b) transactional test. See infra notes 194-286 and accompanying text.


147. See Morrison, 130 S. Ct. at 2887 n.11.

148. Steele v. Bulova Watch Co., 344 U.S. 280, 285 (1952). In deciding that jurisdiction existed, the Court did not find it necessary to pass on the merits of the claim. Id. at 283.

149. 344 U.S. 280, 281-82 (1952).

150. Id. at 285-86.

151. Id. at 286-287. The Court remarked,
and their effects were not confined within the territorial limits of a foreign nation" because Steele bought some of the watch parts in the United States, and some of the watches made their way into the United States.\footnote{152} Furthermore, the Court noted that affording Bulova relief would not “impugn foreign law,” because Mexico’s courts had nullified Steele’s trademark registration of “Bulova” in Mexico.\footnote{153} Significantly, in \textit{Morrison}, the Supreme Court cited Steele for the proposition that the Lanham Act applies extraterritorially.\footnote{154}

Lower courts subsequently created tests to determine when extraterritorial application was proper under the Lanham Act.\footnote{155} As in \textit{Morrison}, settling the inquiry into extraterritoriality was not enough.\footnote{156} Based on the Supreme Court’s analysis in Steele, the Second Circuit adopted a three-factor test that asks: (1) whether the subject defendant is a U.S. citizen; (2) whether such defendant’s conduct has a substantial effect on U.S. commerce; and (3) whether relief would create a conflict with foreign law.\footnote{157}

While the Fourth,\footnote{158} Fifth,\footnote{159} and Eleventh\footnote{160} Circuits have adopted the Second Circuit test with some variation, the First Circuit adheres to a standard based on the Supreme Court’s test for extraterritorial application under the antitrust laws.\footnote{151} That court explained that both antitrust and trademark law carry the risk, absent some extraterritorial enforcement, that violators who have harmed U.S. commerce may evade legal authority altogether.\footnote{162} The First Circuit test requires a lesser showing of effects when the defen-

\footnote{152} Id. at 285-86 (citing \textit{Ski rotes v. Florida}, 313 U.S. 69, 73 (1941)).
\footnote{153} Id. at 286.
\footnote{155} See, e.g., McBee v. Delica Co., 417 F.3d 107, 119-20 (1st Cir. 2005); Reebok Int’l, Ltd. v. Marnatech Enters., Inc., 970 F.2d 552, 554-55 (9th Cir. 1992); Vanity Fair Mills, Inc. v. T. Eaton Co., 234 F.2d 613, 642 (2d Cir. 1956).
\footnote{156} See \textit{Morrison}, 130 S. Ct. at 2880.
\footnote{157} \textit{Vanity Fair}, 234 F.2d at 642. In \textit{Steele}, the Supreme Court noted that the effects of Steele’s conduct reached the United States but never described the effects as “substantial.” See \textit{Steele}, 344 U.S. at 285-87. The language appears to have been derived from the Fifth Circuit’s opinion in the case. See id. (citing \textit{Bulova Watch Co. v. Steele}, 194 F.2d 570 (5th Cir. 1952)). The Fifth Circuit quoted commentary accompanying the Lanham Act that stated that the statute covers trademark uses in foreign, territorial, or interstate commerce, as well as uses in intrastate commerce that have a “substantial economic effect on interstate commerce.” \textit{Steele}, 194 F.2d at 570 (citing Daphne Robert, \textit{Commentary on the Lanham Act}, 268-69 (1948)).
\footnote{158} See \textit{Nintendo, Inc. v. Aeropower Co.}, 34 F.3d 246, 250 (4th Cir. 1994) (requiring significant, rather than substantial, effects).
\footnote{159} See Mar. Rice, Inc. v. Producers Rice Mill, Inc., 518 F.3d 321, 327, 328 n.9 (5th Cir. 2008) (suggesting that “some” effects might be sufficient).
The defendant is a U.S. citizen and disregards the conflict-of-law inquiry. The Ninth Circuit similarly created a test based on antitrust law, which it recently applied in *Love v. Associated Newspapers, Ltd.*, making it the first federal appellate court to consider extraterritorial application of the Lanham Act since *Morrison*.

In *Love*, Mike Love, a band member of The Beach Boys, claimed that the marketing and distribution of a CD in the United Kingdom and Ireland infringed on his limited exclusive right to use The Beach Boys trademark in live performances. After acknowledging the requirement in *Morrison* for a "clear indication of an extraterritorial application," the Ninth Circuit distinguished the Lanham Act’s "sweeping language . . . expressly covering all commerce Congress can regulate" from the Exchange Act’s mere mention of "foreign commerce." The court found it unnecessary to reevaluate its case law concerning the Lanham Act’s coverage of foreign activities. Accordingly, the court turned to its three-factor test for proper extraterritorial application under that Act, which provides that:

1. the alleged violations must create some effect on American foreign commerce;
2. the effect must be sufficiently great to present a cognizable injury to the plaintiffs under the Lanham Act; and
3. the interests of and links to American foreign commerce must be sufficiently strong in relation to those of other nations to justify assertion of extraterritorial authority.

Applying the test, the court held that "all relevant acts occurred abroad" and that Love failed to provide evidence of monetary injury in the United States caused by such acts. The CD was conceived and manufactured overseas and was never sold or distributed in the United States. Therefore, although the Lanham Act was deemed to have extraterritorial application, the claims in *Love* were dismissed based on the Ninth Circuit’s test limiting the extent of that application.

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163. *Id.* at 118 (commenting that when the defendant is a U.S. citizen, "the domestic effect of the international activities may be of lesser importance and a lesser showing of domestic effects may be all that is needed"). *Cf. id.* at 120 ("We hold that the Lanham Act grants subject matter jurisdiction over extraterritorial conduct by foreign defendants only where the conduct has a substantial effect on United States commerce.") (emphasis added).

164. *Id.* at 120. The First Circuit stated that comity considerations should be analyzed as a prudential, rather than extraterritorial, question. *Id.* at 121.

165. *Reebok Intern., Ltd. v. Marnatech Enters., Inc.*, 970 F.2d 552, 554 (9th Cir. 1992) (quoting Star-Kist Foods, Inc. v. P.J. Rhodes & Co., 769 F.2d 1393, 1395 (9th Cir.1985)).

166. 611 F.3d 601 (9th Cir. 2010).


168. *Love*, 611 F.3d at 612-13. In a bit of humor, the court quipped, "Love wishes they could all be California torts." *Id.* at 608.


170. *See Love*, 611 F.3d at 612 n.6.

171. *Id.* at 613.

172. *Id.* at 612-13. The Ninth Circuit noted that the test originated was originally developed for antitrust law. *Id.* at 613.

173. *Id.*

174. *Id.* (refusing to hold that Love’s ticket sales in the United States suffered due to the CD since the alleged confusion would have occurred overseas).

175. *Id.*

176. *Id.*
A number of observations can be made concerning the various courts’ treatment of the Lanham Act’s extraterritorial application. The Love decision offers a glimpse of a statute that has been deemed to have extraterritorial application in large part due to its definition of “commerce.” When the petitioners in Morrison argued that section 10(b) applied abroad because “interstate commerce” was defined to encompass “trade, commerce, transportation, or communication . . . between any foreign country and any state,” the Court responded that it has repeatedly held that statutes with broad language defining “commerce” do not have extraterritorial application, even in instances where “foreign commerce” was expressly included in the definition. Yet, the Lanham Act has been deemed to have extraterritorial application based on its invocation of the Commerce Clause of the Constitution. It is not readily apparent what areas of foreign commerce are covered under the Commerce Clause that would not also be covered by the Exchange Act’s definition of “commerce,” or any other statute’s similarly-worded definition of “commerce.” Nonetheless, when considered together, Morrison and the extraterritorial reach of the Lanham Act suggest that a clear indication of extraterritorial application will not be found based on a statute’s definition of “commerce” unless the statute expressly calls upon the full extent of Congress’ power over commerce.

Additionally, the transactional test created in Morrison and the tests created by the federal circuit courts to determine the scope of the Lanham Act’s extraterritorial application together indicate that the proper application of a particular statute requires a more in-depth analysis. Thus, Morrison sets the stage for a two-step analysis asking: (1) Does the subject statute contain a clear indication of extraterritorial application? and (2) What is the proper scope of its domestic (or extraterritorial) application? The second question, from which the Morrison transactional test and the tests developed by the federal circuit courts.

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179. See Love, 611 F.3d at 612 n.6.
180. Compare U.S. CONST. art. 1, § 8, cl. 3 (“Congress shall have the power . . . [to regulate Commerce] with foreign Nations, and among the several States, and with Indian tribes.”), with 15 U.S.C. § 78c(a)(17) (2010) (“The term ‘interstate commerce’ means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof. The term also includes intrastate use of: (A) any facility of a national securities exchange or of a telephone or other interstate means of communication, or (B) any other interstate instrumentality.”).
181. See Morrison, 130 S. Ct. at 2882.
182. With regard to the Lanham Act though, practitioners should keep in mind that the Supreme Court has yet to hear a case involving the proper scope of extraterritorial application under the Act and therefore has not endorsed any of the federal appellate court tests.
184. Morrison, 130 S. Ct. at 2884-86 (inquiring into the proper domestic application of section 10(b)).
courts for the Lanham Act emerged, gets to the heart of the matter—the proper application of the statute.

Stating that a statute has extraterritorial application when, in reality, that application is limited by considerations of U.S. connections may not be significantly different than stating a statute does not have extraterritorial application when, in reality, so-called domestic application of the statute allows for foreign contacts so long as certain U.S. requirements are met. In both instances, it is the specific degree and type of U.S. contacts necessary to state a claim that really matters. Thus, the essential question is what are the minimum U.S. contacts necessary, if any, to state a claim under the applicable statute. The presumption against extraterritoriality would then only be applied once—in the court’s statutory analysis when answering this question.

Though the analysis in Morrison likely ensures that courts will first look to see if a statute has a clear indication of extraterritorial application, the more important battleground seems to be the second set of tests outlining proper application of a statute where both U.S. and foreign contacts are involved. Indeed, concurring in the Morrison judgment, Justice Stevens commented that “[t]he real motor of the Court’s opinion, it seems, is not the presumption against extraterritoriality but rather the Court’s belief that transactions on domestic exchanges are ‘the focus of the Exchange Act’ and ‘the objects of [its] solicitude.’”

Overall, even though the presumption against extraterritoriality is not a new canon of statutory construction, Morrison has created a more difficult environment for plaintiffs to bring claims involving U.S. and foreign contacts. Defendants will bring more FRCP 12(b)(6) challenges regarding extraterritorial application, asserting that either the statute at issue does not have extraterritorial reach or that the U.S. contacts are insufficient to state a claim. Indeed, in light of Morrison, use of the conduct and effects test in other areas of law that are not “textually plausible” is susceptible to being overruled.

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186. For instance, despite stating that the Lanham Act has extraterritorial reach, the Second Circuit looks for U.S. citizenship and the effect on U.S. commerce when considering claims under the Act. Vanity Fair, 234 F.2d at 642. Additionally, the Morrison transactional test allows a claim under section 10(b), a statute without extraterritorial reach, so long as the securities purchase or sale occurs on a domestic exchange or otherwise is a domestic transaction. Morrison, 130 S. Ct. at 2887.

187. This is especially true in a time of globalization where an increasing number of cases involve both U.S. and foreign contacts. For a different perspective on extraterritorial application, see United States v. Philip Morris USA Inc., 566 F.3d 1095, 1130 (D.C. Cir. 2009), which defined “true” extraterritorial reach as “foreign conduct that has no conduct on the United States” (emphasis added).

188. But see Morrison, 130 S. Ct. at 2877-78, 2884 (applying the presumption against extraterritoriality when determining the extraterritorial reach of section 10(b) and again when determining the domestic activity needed to state a section 10(b) claim). In response to the plaintiff’s argument in Morrison for domestic application of section 10(b), Justice Scalia stated that the “presumption here (as often) is not self-evidently dispositive, but its application requires further analysis.” Id. at 2884.

189. Id. at 2894 (Stevens, J., concurring) (citations omitted).

190. Id. at 2884 n.9 (majority opinion).

191. It should be noted, however, that in determining if a clear indication of extraterritorial application exists, Morrison still allows courts to consult statutory context in deriving the most faithful reading of the text.” Id. at 2883 (stating that a clear statement such as “this law applies abroad” is not necessary for a statutory finding of extraterritorial reach). For instance, in a post-Morrison decision, the Court of Appeals for the Eleventh Circuit stated that a clear expression of congressional intent that a statute apply abroad was
will likely be shaped by courts focusing on the language and objectives of a statute and developing tests therefrom.\textsuperscript{192} An absence of statutory direction regarding conflicts with foreign laws will weigh in favor of a more limiting test.\textsuperscript{193}

In addition to these broader statutory inquiries, \textit{Morrison} generated specific concerns under the Exchange Act with respect to the effect of its new transactional test on section 10(b) actions. The next section discusses the two prongs of the \textit{Morrison} transactional test in detail, as well as the test’s possible expansion in light of the recently completed Dodd-Frank study on section 10(b) private rights of action.

\section{V. The New Wave—Section 10(b) Transactional Test}

After deciding in \textit{Morrison} that section 10(b) of the Exchange Act did not have extraterritorial application,\textsuperscript{194} the Supreme Court created a test to determine proper domestic application under the Act where foreign contacts are involved.\textsuperscript{195} The \textit{Morrison} transactional test requires either: (1) a purchase or sale of a security listed on a domestic exchange or (2) a purchase or sale of a security made in the United States.\textsuperscript{196} While federal courts have already had occasion to interpret the \textit{Morrison} transactional test in a variety of settings,\textsuperscript{197} there are critical questions that remain unresolved. The analysis below begins with an examination of the first prong of the \textit{Morrison} transactional test.

\textsuperscript{192}One commentator concluded that \textit{Morrison} “giv[es] courts total discretion to discern the ‘focus’ of any given statute.” Anthony J. Colangelo, \textit{A Unified Approach to Extraterritoriality}, 97 Va. L. Rev. 1019, 1045-46 (2011). As evidenced in \textit{Morrison}, there is room to debate the focus of the congressional concern of a statute. \textit{Compare Morrison}, 130 S. Ct. at 2884 (concluding that domestic exchanges and domestic transactions were the primary concern of Congress), \textit{with id.} at 2894 (Stevens, J., concurring) (arguing that “public interest” and the “interests of investors” were the focus of the Exchange Act). \textit{See also} Sorota v. Sosa, 842 F. Supp. 2d 1345, 1349 (S.D. Fla. 2012) (focus of RICO is “enterprise”), \textit{with CGC Holding Co., LLC v. Hutchens}, 824 F. Supp. 2d 1193, 1209 (D. Colo. 2011) (focus of RICO is “racketeering activity”).

\textsuperscript{193}See \textit{Morrison}, 130 S. Ct. at 2885 (majority opinion).

\textsuperscript{194}Id. at 2883.

\textsuperscript{195}Id. at 2886 (referring to the adopted test as the “transactional test”).

\textsuperscript{196}Id.

A. The First Wave—Purchase or Sale of a Security Listed on a U.S. Exchange

Under the first prong of the Morrison transactional test, a purchase or sale of a security listed on a domestic exchange is subject to section 10(b). The inquiry under this prong focuses on the circumstances in which the listing requirement is met. In this respect, there are two ways that foreign companies seek to access capital markets through U.S. exchanges. First, ordinary shares, which are the foreign equivalent of common stock, may be listed on U.S. exchanges to trade as a U.S. company’s stock normally would. Second, ordinary shares of a foreign issuer may be represented on U.S. exchanges through American Depositary Receipts (ADRs), which are securities that indicate ownership of ordinary shares but avoid the currency complications of foreign investments.

After Morrison, plaintiffs have argued that so long as a company’s shares are listed or represented on a U.S. exchange, a purchase or sale of stock on a foreign exchange satisfies the first prong of the transactional test. Courts have consistently rejected this argument, explaining that such an outcome would undermine Morrison’s focus on domestic exchanges.

For instance, in In re Alstom SA, Securities Litigation, class members had
their section 10(b) action dismissed where their purchases of a French company’s shares occurred on a foreign stock exchange, despite the fact that the company’s ADRs traded on the NYSE.\textsuperscript{206} The court explained that \textit{Morrison} was “concerned with the territorial location where the purchase or sale was executed and the securities exchange laws that governed the transaction.”\textsuperscript{207} Similarly, in \textit{S glambo v. McKenzie},\textsuperscript{208} where a Canadian company’s shares traded both on the Toronto Stock Exchange (TSE) and the American Stock Exchange (AMEX), the court summarily dismissed class members who had only purchased or sold common stock on the TSE.\textsuperscript{209} Overall, in determining whether a purchase or sale involves a security listed on a U.S. exchange, the lower courts uniformly have based their holdings on the territorial location of the exchange where the transaction at issue occurred.

This territorial application is consistent with the directives expressed in \textit{Morrison}, focusing on “purchases and sales of securities \textit{in the United States}.”\textsuperscript{210} Indeed, if the transactional test could be met so long as stock that was purchased or sold on a foreign exchange had an identical or similar security listed on a U.S. exchange, one would have expected \textit{Morrison}’s outcome to be different because National Australia had ADRs listed on the NYSE.\textsuperscript{211}

Consistent with \textit{Morrison}, courts have allowed purchases or sales of ADRs made on a U.S. exchange to proceed.\textsuperscript{212} This is not to say all ADR purchases necessarily are within section 10(b)’s scope. There has been some disagreement as to whether a purchase or sale of an ADR that trades over-the-counter satisfies the \textit{Morrison} transactional test.\textsuperscript{213} The next section, which discusses purchase or sales in the United States that do not occur on U.S. exchanges, will examine this situation further.
Overall, the listing of foreign stock directly, or the representation of foreign stock through ADRs, on a U.S. exchange alone is not enough to warrant section 10(b) coverage under the *Morrison* transactional test. To satisfy the listing requirement of the first prong of the test, courts have required that the transaction at issue take place on a U.S. exchange. Purchases of ADRs on a domestic exchange come within section 10(b) coverage. On the other hand, U.S. investors who purchase or sell securities outside of this country, whether on a stock exchange, over-the-counter, or in private transactions, are left without a section 10(b) claim unless they can show that, pursuant to the second prong of the transactional test, the purchase or sale was made in the United States. The next section explores the scope of transactions covered by the second prong.

B. A More Tumultuous Wave—Purchase or Sale of Any Other Security in the United States

The second prong of the *Morrison* transactional test raises a host of questions. In addressing this prong, the Supreme Court referenced “purchases or sales made in the United States” as well as “domestic transactions.” Unfortunately, this terminology fails to provide sufficient light on the type of transactions that qualify under the second prong. Perhaps due to this lack of guidance, there is already a wealth of case law interpreting this terminology.

Many attempts by plaintiffs to satisfy the second prong of the *Morrison* transactional test have failed. One of the arguments not surprisingly rejected by courts is that a purchase of stock on a foreign exchange is a domestic transaction because the purchase was made by a U.S. resident. Nothing in *Morrison* indicates that for section 10(b) purposes the location of a transaction turns on a purchaser’s residency or citizenship. As one court observed, “a foreign resident can make a purchase within the United States, and a United States resident can make a purchase outside the United States,” but section 10(b) only reaches the former. Indeed, ascertaining the reach of section 10(b) based on the U.S. residency (or citizenship) of the complainant would inappropriately revive a primary component of the abandoned “effects” test. As a consequence, under *Morrison’s* transac-

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214. See *Morrison*, 130 S. Ct. at 2884-86.
218. Plumbers’ Union, 735 F. Supp. 2d at 178.
219. Id.
tional test, section 10(b) does “not extend to foreign securities trades executed on foreign exchanges even if purchased or sold by American investors.”

Place of injury has also been rejected as a basis for section 10(b) coverage under Morrison. One court commented, “there is no textual or logical basis [in the Exchange Act] for making injury a sufficient condition for the statute’s application without the existence of a domestic purchase or sale.” After Morrison, therefore, a U.S. investor injured in the United States from a purchase or sale transacted abroad is without recourse under section 10(b).

Next, consistent with Morrison’s rejection of the conduct test, courts have deemed the place of deceptive conduct irrelevant to the transactional test. For example, in SEC v. Goldman Sachs Group, Inc., the SEC referenced Goldman Sachs’s actions in the United States in an attempt to state section 10(b) claims that involved purchases of notes by a German bank and sales of credit default swaps by a Netherlands bank. The alleged deceptive conduct included transmission of false and misleading marketing materials and emails. The court dismissed the claims, explaining that domestic conduct is no longer the test for section 10(b) liability.

Likewise, assertions that a transaction ought to be considered a domestic transaction where the decision to invest was made in the United States have proven futile. Concluding that an investment decision in the United States to purchase stock has “no bearing on where the stock was ultimately purchased,” courts have rejected this argument.

221. Id. at 625-26 (rejecting the claim of a U.S. retirement fund that had bought Swiss stock on a Swiss exchange).
222. UBS Secs. Litig., 2011 WL 4059356, at *8; Plumbers’ Union, 753 F. Supp. 2d at 178-79.
223. Plumbers’ Union, 753 F. Supp. 2d at 179.
224. See, e.g., Basis Yield Alpha Fund (Master) v. Goldman Sachs Grp., Inc., 798 F. Supp. 2d 533, 537 (S.D.N.Y. 2011) (noting that the complaint includes “numerous instances of U.S.-based conduct” but fails to allege that a purchase or sale occurred in the United States); SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147, 158 (S.D.N.Y. 2011) (“The shortcoming of all of this U.S.-based conduct is precisely that—it is just conduct.”); Plumbers’ Union, 753 F. Supp. 2d at 179. In Cornwell, the court discussed how, in Morrison, the Supreme Court: discarded the conduct and effects tests, which valued “whether ‘the harmed investors were American or foreign’” did not place importance on the place where the deceptive conduct began; and referred to EEOC v. Arabian American Oil Co., 499 U.S. 244 (1991), a case where extraterritorial application was rejected despite some domestic contacts. Cornwell, 729 F. Supp. 2d at 626 (referring to Morrison v. Nat’l Austl. Bank Ltd., 130 S. Ct. 2869, 2879, 2884-85 (2010)).
226. Id. at 147.
227. Id. at 158-61.
230. Plumbers’ Union, 753 F. Supp. 2d at 178 (citing plaintiff’s rejected argument for section 10(b) coverage in Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 622 (S.D.N.Y. 2010)).
One court reasoned that allowing claims just because “some acts that ultimately result[ed] in the execution of the transaction abroad [took] place in the United States” would only serve to revive the rejected conduct test.\textsuperscript{232}

Several plaintiffs have advocated a seemingly more persuasive position that also has met with failure thus far, contending that purchase orders placed in the United States for stock listed on a foreign exchange are domestic transactions under\textit{Morrison}.\textsuperscript{233} As one court reasoned, “the Exchange Act was not intended to regulate foreign exchanges” and that, due to the potential for conflicts with foreign law, “United States securities laws should defer to the law of the country where the security is exchanged.”\textsuperscript{234} Based on\textit{Morrison}'s rationale, therefore, it may well be that transactions effected on foreign exchanges can never be domestic transactions coming within section 10(b) coverage.

After having gone through the rejected bases for defining a domestic transaction—that is, residency or citizenship, location where injury occurred, location of deceptive conduct, location of investment decision, and location where the purchase orders were placed—it is time to examine a basis that has yielded inconsistent responses from courts. The theory that domestic transactions under the second prong of\textit{Morrison} referred to “purchases and sales of securities explicitly solicited by the issuer within the United States” was first suggested and adopted in\textit{Stackhouse v. Toyota Motor Co.},\textsuperscript{235} a memorandum opinion designating a lead plaintiff for a securities class action suit.\textsuperscript{236} A decision from the Southern District of New York subsequently accepted this interpretation of the\textit{Morrison} transaction test,\textsuperscript{237} but that district has declined to consistently follow it.\textsuperscript{238} To add to this division, the District Court for the District of Colorado found\textit{Stackhouse}'s interpretation unpersuasive.\textsuperscript{239} In\textit{Cascade Fund, LLP v. Absolute Capital Management Holdings, Ltd.},\textsuperscript{240} the court pointed out that\textit{Morrison} did not attribute any significance to the place of solicitation in...
reaching its holding.241 Indeed, it is questionable whether any part of the transactional test relies on solicitation, as this would rekindle aspects of the conduct test that the Supreme Court expressly overruled.242

More recently, the District Court for the Southern District of New York has focused on the notion of “irrevocable liability” rather than solicitation when considering domestic transactions under Morrison.243 This treatment stems from an analysis of case law and the statutory language of the Exchange Act performed by the court in Plumbers’ Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.244 There, the court determined that a purchase under the Exchange Act occurs when the parties incurred “irrevocable liability” to consummate the transaction.245

In April 2012, the Second Circuit adopted a similar test for domestic transactions under Morrison.246 The court stated in Absolute Activist Value Master Fund Ltd. v. Ficeto that a domestic transaction requires irrevocable liability to be incurred or title to be transferred within the United States.247 In discussing irrevocable liability, the court noted that the definitions of the terms “purchase” and “sale” in the Exchange Act include any contract for such undertaking.248 The court explained that the point at which parties contractually obligate themselves to take and pay for a security or deliver a security can be used to determine the locus of that securities transaction.249

The facts needed to satisfy the irrevocable liability analysis for domestic transactions under Morrison are unresolved, as the post-Morrison cases using the analysis have been either dismissed for failure to allege sufficient facts or granted leave to amend the complaint with further facts.250 In Absolute Activist Value Master Fund Ltd., the court suggested that facts regarding “the formation of the contracts, the placement of purchase orders, the

241. Id.
244. 753 F. Supp. 2d 166 (S.D.N.Y. 2010).
245. Id. at 177.
246. See Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 69 (2d Cir. 2012).
247. Id.
248. Id. at 68-69.
249. Id. at 67 (discussing 15 U.S.C. § 78c(a)(13)–(14) (2011)). When construing the terms “purchase” and “sale” under the Exchange Act, courts have asked when the subject party became “irrevocably bound” to buy or sell the securities such that “his rights and obligations became fixed.” Portnoy v. Revlon, Inc., 650 F.2d 895, 898 (7th Cir. 1981). See also DiLorenzo v. Murphy, 443 F.3d 224, 229 (2d Cir. 2006) (stating that a purchase occurs under the Exchange Act once the purchaser “fully and irrevocably pay[es] for the securities”); Blau v. Ogsbury, 210 F.2d 426, 427 (2d Cir. 1954) (explaining that a person is a purchaser under the Exchange Act when he “incur[s] an irrevocable liability to take and pay for the stock”).
250. Absolute Activist, 677 F.3d at 68.
252. See Absolute Activist, 677 F.3d at 71.
passing of title, or the exchange of money" would help to show that the parties became irrevocably bound or that the title passed in the United States.253 It is also instructive to make note of one of the instances where the alleged facts were found lacking. In SEC v. Goldman Sachs & Co.,254 the SEC alleged that the securities transaction at issue closed in New York.255 The court held, however, that there were no facts alleging that any party incurred irrevocable liability in the United States.256 It explained that, under Morrison, “the closing, absent ‘a purchase or sale . . . made in the United States,’ is not determinative.”257 Thus, it appears that courts will not presume that parties incurred irrevocable liability at the closing, even though that may often be the case.258

Other interpretations of “domestic transactions” under Morrison have considered the location where the subscription agreements were accepted.259 For instance, in Anwar v. Fairfield Greenwich Ltd.,260 a case brought by foreign investors against Bernie Madoff’s foreign feeder funds, the plaintiffs argued that the second prong of the Morrison transactional test was met because, although they sent their subscription agreements to foreign administrators, a transaction did not occur until the agreements were accepted in the defendants’ New York offices.261 With no securities purchases or sales “executed on a foreign exchange,” the court stated that Anwar entailed a “novel and more complex application of Morrison’s transactional test.”262 The court concluded that, given the unique financial interests, transaction structures, and party relationships involved, more facts were needed to determine if plaintiffs’ purchases occurred in the United States.263

To consider the location where the subscription agreement was accepted is consistent with the irrevocable liability analysis. Acceptance of an agreement presumably forms a contract that makes the parties liable to each other if they fail to pay for or deliver the

253. Id. at 70.
255. Id. at 153.
256. Id. at 159-61.
257. Id. at 158-59 (quoting Morrison v. Nat’l Austl. Bank Ltd., 130 S. Ct. 2869, 2886 (2010)).
258. See BLACK’S LAW DICTIONARY 291 (9th ed. 2009) (defining “closing” as when “the transaction is consummated”).
259. See, e.g., Cascade Fund, LLP v. Absolute Capital Mgmt. Holdings Ltd., No. 08-cv-01381-MSK-CBS, 2011 WL 1211511, at *7 (D. Colo. Mar. 31, 2011) (granting defendant’s motion to dismiss after concluding that completion of the transaction did not occur until defendant accepted the subscription agreement in the Cayman Islands); Anwar v. Fairfield Greenwich Ltd., 728 F. Supp. 2d 372, 405 (S.D.N.Y. 2010) (mandating further discovery before ruling on defendant’s motion to dismiss where plaintiff’s transactions were not on foreign exchanges and where the subscription agreements were allegedly accepted in New York).
261. Id. at 405.
262. Id. The court noted that the securities were “listed . . . [but] not actually traded” on a foreign exchange.
263. Id. For another case brought by Madoff’s feeder funds with similar results, see In re Optimal U.S. Litigation, 813 F. Supp. 3d 351, 373 (S.D.N.Y. 2011). In that case, the court denied a defendant’s motion to dismiss, stating that a more fully developed factual record was needed to establish “where all of Plaintiffs’ shares were ‘issued,’ where they wired their subscription payments, what the statement ‘WE BOUGHT FOR YOUR ACCOUNT IN: NYS’ means, and where their subscription agreements were ‘accepted.’” Id.
security as promised. Thus, under this approach, a plaintiff who pleads facts alleging that a private securities agreement was accepted in the United States may well satisfy the irrevocable liability analysis for demonstrating a domestic transaction under *Morrison*.

Arguably, there are instances where courts have interpreted *Morrison* too broadly to exclude certain privately placed securities transactions from section 10(b) coverage. For example, in *Elliott Associates v. Porsche Automobil Holding SE*, the court considered whether there was a substantive distinction between the placement of a buy order in the United States for a security traded abroad, which it did not consider a "domestic transaction," and the execution of a swap agreement in the United States referencing foreign stock. Plaintiffs argued that, although the Volkswagen ordinary shares underlying their swap agreements traded on a German exchange, the agreements qualified as domestic transactions under *Morrison* because they were signed in the United States. The court determined that the economic reality was that the swap agreements were "essentially 'transactions conducted upon foreign exchanges and markets,' and not 'domestic transactions' that merit[ed] the protection of [section] 10(b)." Referencing *Morrison*, the court relied on the presumption against extraterritoriality and that the Exchange Act was not intended to regulate foreign securities transactions.

In a more expansive decision denying section 10(b) coverage, *In re Société Générale Securities Litigation*, the court held that a transaction involving over-the-counter ADRs was not a domestic transaction under *Morrison*. The court reasoned that "[t]rade in

264. See *Restatement (Second) of Contracts* § 1 (1981) ("A contract is a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty.").

265. See, e.g., *Elliott Assocs. v. Porsche Automobil Holding SE*, 759 F. Supp. 2d 469, 476 (S.D.N.Y. 2010) (dismissing a section 10(b) claim where the swap agreement was executed in the United States but the underlying shares traded on a foreign exchange).

266. 759 F. Supp. 2d 469 (S.D.N.Y. 2010) (U.S. and foreign hedge funds, which were all managed from New York, sued foreign companies under the Exchange Act.).

267. Id. at 474-76. A security swap agreement is a private contract that fluctuates in value based on the price of the shares referenced within; it is not traded on any exchange.

268. Id. at 474.

270. Id. at 476.

271. Id. at *6.


273. Id. at *6.

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ADRs is considered to be a ‘predominantly foreign securities transaction.’” 274 For further support, the court focused on the foreign defendant’s ADRs that were traded “in a less formal market [than a U.S. exchange] with lower exposure to U.S.-resident buyers.” 275 Both Elliott Associates and Société Générale unduly expand Morrison’s scope. Because the second prong of the transactional test asks if “the purchase or sale is made in the United States,” an execution of a swap agreement in the United States should satisfy Morrison. 276 Likewise, the focus with respect to over-the-counter ADRs should be on whether the ADR was purchased in the United States. By focusing instead on the foreign shares underlying these securities, the familiarity of the market where the ADRs are traded, and the number of U.S. resident purchasers, the court in Société Générale misapplied the Morrison transactional test.

After Morrison, parties may seek—by contractual agreement—to bring their transaction within section 10(b) coverage. Hence, a question remains as to what extent parties can use contractual language to satisfy Morrison’s “domestic transactions” prong. In Quail Cruises Ship Management Ltd. v. Agencia de Viagens CVC Tur Limitada, 277 for example, a foreign corporation argued that the private purchase of foreign stock from another foreign corporation constituted a purchase or sale in the United States under Morrison because the share purchase agreement contained a forum selection clause providing for U.S. law and designated U.S. law offices as the place of closing. 278 The court dismissed the claim, explaining that “[a]dopting a rule that permits the intent of parties located abroad and contracting from their home countries in a wholly off-shore transaction to apply United States securities law is inconsistent with Morrison.” 279

On appeal, the Eleventh Circuit vacated and remanded the decision. 280 The appellate court observed that the plaintiffs had alleged that the closing “actually occurred in the United States.” 281 The court then relied on the definition of “closing” in Black’s Law Dictionary to conclude that the transaction was consummated at closing. 282 Lastly, the court found that the purchase agreement confirmed that the sale occurred at this domestic closing because the agreement stated that the title to the shares did not transfer until

274. Id. at “4,” “6” (quoting Copeland v. Fortis, 685 F. Supp. 2d 498, 506 (S.D.N.Y. 2010)). But In re SCOR Holding (Switzerland) AG Litigation, 537 F. Supp. 2d 556 (S.D.N.Y. 2008), the case from which Copeland derived this statement, does not actually stand for this assertion. See Copeland, 685 F. Supp. 2d at 506 (citing In re SCOR Holding (Switz.) AG Litig., 537 F. Supp. 2d 556, 561 (S.D.N.Y. 2008)). Prior to Morrison, the court in SCOR Holding merely stated: “Assuming that the purchase of [ADRs] on the NYSE . . . may be viewed as predominantly foreign securities transactions, it is not contested here that this Court has subject matter jurisdiction over claims arising out of such transactions under the effects test without consideration of the conduct test.” SCOR Holding, 537 F. Supp. 2d at 562. Thus, since the jurisdiction of the ADRs was uncontested, the court had no occasion to make a determination that the ADRs actually were predominantly foreign securities.

275. In re Société Générale Secs. Litig., No. 08 Civ. 2495(RMB), 2010 WL 3910286, at *6 (S.D.N.Y. Sept. 29, 2010) (quoting Copeland, 685 F. Supp. 2d at 506). Thus, while section 10(b) evidently covers purchases or sales of ADRs listed on U.S. exchanges, the statute may not cover ADRs traded over-the-counter.


278. Id. at 1347-48 (S.D. Fla. 2010), vacated, 645 F.3d 1307 (11th Cir. 2011).

279. Id. at 1350.

280. Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada, 645 F.3d 1307, 1311 (11th Cir. 2011).

281. Id. at 1310.

282. Id. (citing Black’s Law Dictionary 291 (9th ed. 2009)).
This decision suggests that section 10(b) coverage may be available for transactions where the parties bought or sold securities in accordance with contractual language mandating that the closing occur in the United States and that the title transfer at closing.

Beyond this perception, Quail Cruises presents an interesting contradiction between the Morrison transactional test and the policy underlying Morrison against interfering with foreign securities regulation. The Eleventh Circuit focused on applying the Morrison transactional test as literally adopted. The district court below, on the other hand, looked to Morrison’s policy rationale, determining that allowing the section 10(b) claim in this setting would undermine congressional intent concerning the regulation of foreign transactions. By creating a test that ignores U.S. conduct and the U.S. connections of the parties, Morrison laid the groundwork for essentially foreign claims such as this to proceed.

Nonetheless, the interpretation of “domestic transactions” that seems to best comport with Morrison and the Exchange Act is the irrevocable liability analysis. That analysis takes into account the statutory meaning of the words “purchase” and “sale” and does not revive aspects of the rejected conduct and effects test, as a focus on “solicitation” would. Although the facts needed to establish proof of irrevocable liability in a given situation frequently may not be clear, mutual acceptance of the agreement’s terms and conditions in the United States should be important. As for whether parties can invoke U.S. federal securities law based on contractual language alone, it appears they cannot. They may, however, be able to opt into section 10(b) coverage if contractual language provides that the closing and title transfer occur in the United States and the parties then perform accordingly. With that possibility looming, it seems that the transactional test may produce results that Morrison did not foresee.

The last section considers private right of actions after Morrison and whether the emerging globalization of securities markets calls for action by Congress.

C. The Ultimate Wave—Private Right of Actions After Morrison

In response to the study called for in the Dodd-Frank Act, parties ranging from foreign governments to pension funds to law professors have weighed in on whether Congress ought to reinstate some form of the conduct and effects test for private right of actions under section 10(b). Most foreign governments argue that expanding Morrison would

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283. Id. at 1310-11. This comports with the Second Circuit’s decision in Absolute Activist Value Master Fund Ltd. v. Fiat, 677 F.3d 60, 68 (2d Cir. 2012), which considered the location where the title transferred in determining if a domestic transaction under Morrison had occurred.

284. See Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2886 (2010). The Court stated that it developed a “clear test” to avoid the interference with foreign securities regulation that application of section 10(b) abroad would produce. Id. It seems counterintuitive then that a foreign-cubed case would satisfy the transactional test.

285. See Quail Cruises, 645 F.3d at 1310-11 (examining the transaction to determine if the transaction “occurred in the United States” as required under the Morrison transactional test).

286. See Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada, 732 F. Supp. 2d 1345, 1350 (S.D. Fla. 2010) (stating that even if the transaction closed in the United States, the purchase or sale occurred abroad because, under Morrison, it is Congress’s intent, not the parties’ intent, that is “dispositive of the application of federal securities law to foreign securities transactions”).

create conflicts with foreign law.\textsuperscript{288} For instance, unlike the United States, many European countries have not adopted or have limited class actions, have limited discovery, do not allow contingency fees, and require the loser to pay litigation costs.\textsuperscript{289} Instead, these countries have made deliberate decisions not to provide the same remedies as are available in the United States.\textsuperscript{290} Additionally, the United Kingdom, France, Germany, and Switzerland argue that expansion of \textit{Morrison} is not necessary because each country has remedies available to U.S. investors who invest in foreign markets.\textsuperscript{291} Several of the governments emphasize cooperation between regulating authorities as an effective way to deal with transnational securities.\textsuperscript{292} Overall, foreign governments advocate that the section 10(b) private right of action should remain limited by \textit{Morrison}.

U.S. pension funds, on the other hand, advocate that section 10(b) ought to extend to all purchases and sales of securities by financial institutions located in the United States and by individuals and entities who reside in the United States.\textsuperscript{293} Five Ohio pension funds assert that U.S. and European Union brokers are required by legislation to execute purchases and sales on the exchange that, under the circumstances, most benefits the client.\textsuperscript{294} Investors therefore have no idea through which exchange(s) their orders will be


\textsuperscript{289} See Taylor, \textit{supra} note 287, at 2-3 (United Kingdom); La Directrice des Affaires Juridiques, \textit{supra} note 288, at 4 (France). The comment by France even provided, “French courts would almost certainly refuse to enforce a court judgment in a U.S. ‘opt out’ class action because such a judgment violates French constitutional principles and public policy.” Id. at 7. For a detailed comparison of U.S. and foreign securities law, see Letter from Mouvement des Entreprises de Fr. et al., to Elizabeth Murphy, Sec’y, SEC, at app. (Feb. 18, 2011), available at \url{http://www.sec.gov/comments/4-617/4617-46.pdf}.

\textsuperscript{290} See Taylor, \textit{supra} note 287, at 2-3 (United Kingdom); La Directrice des Affaires Juridiques, \textit{supra} note 288, at 7 (France).


directed. Additionally, many states mandate that state pension funds engage in prudent diversification. For some funds, this requires the purchase of securities on foreign exchanges. Several funds contend that a private right of action for U.S. investors, regardless of where the affected securities transaction(s) are consummated, is essential to effectuate the Exchange Act’s primary purpose of protecting investors.

A comment by a group of forty-two law professors also supports extending section 929P of the Dodd-Frank Act to private plaintiffs. The professors argued that, with the fluid and international nature of modern financial markets, the place of a trade is becoming increasingly arbitrary. For instance, they predicted that the proposed merger of the Deutsche Borse and NYSE Euronext (which subsequently was scuttled) would result in offshore trades that, in the past, would have been executed in the United States. Rather than focus on where a trade occurs, the group urged Congress to focus on where an investor is induced to trade. Additionally, when foreign issuers list their stock in the United States and voluntarily subject themselves to U.S. securities laws, as National Australia did in Morrison by offering ADRs on the NYSE, the group argued that concerns about international comity are minimized. Lastly, the professors pointed to the numerous dismissals of securities fraud cases since Morrison as evidence of its shortcomings.

295. Id. See also Letter from National Ass’n of Shareholder & Consumer Attorneys, to Elizabeth Murphy, Sec’y, SEC, at 21 (Feb. 18, 2011) (noting that the exchange used is not often under the investor’s control), available at http://www.sec.gov/comments/4-617/4617-18.pdf.

296. See Ohio Pub. Emps. Ret. Sys., supra note 293, at 7-8; DiNapoli, supra note 293, at 2. As of December 31, 2010, about 29 percent of the New York State Common Retirement Fund’s public equities were international, with most of them purchased on foreign exchanges. Id. at 2.

297. See Ohio Pub. Emps. Ret. Sys., supra note 293, at 8 (stating that “an investor seeking to have automotive industry representation simply cannot avoid buying Toyota or Volkswagen and cannot buy into energy without purchasing BP or Royal Dutch Shell”). As an example of the potentially negative effects of Morrison, the trustee for the New York State Common Retirement Fund noted that the fund purchased BP shares on a foreign exchange and, thus, may not be able to continue its role as co-lead plaintiff against BP concerning misrepresentations about the recent oil spill in the Gulf of Mexico. DiNapoli, supra note 293, at 2-3. The trustee pointed out that 40 percent of BP’s assets and workers are in North America, that 40 percent of its ordinary shares are owned by U.S. investors, and that BP has two wholly-owned U.S. subsidiaries. Id. For a further discussion of Morrison’s impact on institutional investors, see Ward & Baker, supra note 271.


299. Bartlett, supra note 287, at 5.

300. Id. at 7.


302. Bartlett, supra note 287, at 7 (arguing that “[i]f a person in the U.S. is approached by brokers in the U.S. and is led to execute a trade on a foreign exchange, surely that trade is territorial, not extraterritorial”). In urging the Commission to reflect on the benefits of reinstating the conduct and effects test, the professors suggested that the Commission “consider analogies to Regulation S’s ‘directed selling efforts’” and “the extent of trading in categories of economically equivalent instruments,” such as ADRs and swaps backed by foreign shares. Id. at 8.

303. Id. at 8-10. The group of professors remarked that plaintiffs in Morrison did not emphasize these facts before the Supreme Court. Id. at 13.

304. See id. at 13-18 (describing twelve cases dismissed or pending a motion to dismiss since Morrison). Many of the professors were also persuaded by the scenario painted by Justice Stevens in Morrison, where a...
By comparison, they claimed that the conduct and effects test “captures the potential complexity of the relationships among investors and issuers.”

The Commission issued its report based on the Dodd-Frank study in April 2012. Rather than recommend a particular course of action, the Commission put forth several alternatives regarding private right of actions for Congressional consideration. These alternatives ranged from extending the conduct and effects test that Congress granted the Commission and DOJ in the Dodd-Frank Act, to supplementing and clarifying the second prong of the Morrison transaction test, to taking no action at all. Issuing a dissenting statement on the report, SEC Commissioner Luis Aguilar expressed his “strong disappointment,” citing the report’s lack of any specific recommendations and its failure to accurately portray the “immense and irreparable investor harm” resulting from Morrison.

In the SEC comments submitted by the various parties, the main disagreement appears to concern whether section 10(b) coverage ought to be available to U.S. investors who purchased or sold securities of foreign issuers. In that situation, the United States has an interest in protecting U.S. investors, while a foreign government has an interest in policing issuers within its country. The American Law Institute’s Restatement (Third) of Foreign Relations Law observes that, with the increasing globalization of securities markets, territorial factors may become less relevant. Conversely, the place of representations and negotiations, the nationality and residency of the parties, and the effect of the

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305. Id. at 11. Note that one of the authors of this article, Marc I. Steinberg, joined this comment letter.
306. See generally STUDY ON THE CROSS-BORDER SCOPE, supra note 62.
307. Id. at 58-59.
308. See id. at 60-64. The Commission offered variations on the conduct and effects test for private rights of actions, such as an additional requirement “that the plaintiff’s injury resulted directly from conduct within the United States” or that a U.S. investor brought the complaint. Id. at 61.
309. See id. at 64-69. Options presented for consideration included:
   1. Permit Investors to Pursue a Section 10(b) Private Action for the Purchase or Sale of any Security that Is of the Same Class of Securities Registered in the United States, Irrespective of the Actual Location of the Transaction
   2. Authorize Section 10(b) Private Actions Against Securities Intermediaries that Engage in Securities Fraud While Purchasing or Selling Securities Overseas for U.S. Investors
   3. Permit Investors to Pursue a Section 10(b) Private Action if They Can Demonstrate that They Were Induced While in the United States to Engage in the Transaction, Irrespective of Where the Actual Transaction Occurred
   4. Clarify that an Off-Exchange Transaction Takes Place in the United States if Either Party Made the Offer to Sell or Purchase, or Accepted the Offer to Sell or Purchase, While in the United States

Id. at 64-68.
310. See id. at 57-58 (noting that this approach would leave interpretation of Morrison to the courts).
313. Id. § 416(2)(b).
transaction or conduct on U.S. markets and investors\textsuperscript{315} become more important.\textsuperscript{316} Clearly, the locale of a transaction will become increasingly irrelevant if international exchange mergers become widespread. If the Exchange Act is to adequately protect U.S. investors and markets in the future, non-territorial factors, such as those set forth in the Restatement, must play a pivotal role in determining the scope of the section 10(b) private right of action.\textsuperscript{317} For these reasons, Congress needs to reconsider the substantive scope of section 10(b) as applied to transactions consummated abroad.

VI. Conclusion

\textit{Morrison} has significant ramifications. Overall, the decision (1) altered the longstanding treatment of extraterritoriality as a jurisdictional issue; (2) rendered it more difficult to overcome the presumption against extraterritoriality under federal law; and (3) dramatically narrowed the scope of section 10(b) with respect to transnational frauds. The first two changes primarily have affected federal law outside of U.S. securities law. Statutory requirements are being scrutinized after \textit{Morrison} to ensure that they are not incorrectly characterized as jurisdictional issues. Additionally, \textit{Morrison}'s strict approach to the presumption against extraterritoriality is driving discussions where a statute’s extraterritorial reach is unsettled. It is the creation of the transactional test, however, that will have the most lasting reverberations on the legal tapestry.

Both securities law and non-securities law have been impacted by the transactional test, but in very different ways. The focus in securities law will be gaining an understanding of what it means to have a “domestic transaction” under \textit{Morrison}. This may entail development of the irrevocable liability analysis and possibly some incorporation of contract law concepts. On the whole, with respect to private rights of action, it can be said that the transactional test sets a much higher threshold for section 10(b) claims than the now defunct conduct and effects test ever did.

As for non-securities law, \textit{Morrison} can be expected to guide the important development of the standards that instruct courts as to the proper application of a statute. RICO is likely the first of many statutes to be examined by courts in accordance with the process set forth in \textit{Morrison}—that is, the process of first identifying the focus of a statute based on its statutory language and legislative history and then deciphering a minimum-U.S.-contact test in accordance with that focus, all the while being mindful of the presumption against extraterritoriality. With the globalization of finance and business markets, ascertaining the requisite U.S. nexus under an applicable statute will become increasingly critical in discerning the boundaries of U.S. law.

\textsuperscript{314} Id. § 416(2)(c). This factor may be particularly important when seeking to protect members of the United States armed forces stationed abroad. \textit{Id} at rptr. note 2.

\textsuperscript{315} See id. § 416(2)(a) (considering “whether the transaction or conduct has, or can reasonably be expected to have, a substantial effect on a securities market in the United States for securities of the same issuer or on holdings in such securities by United States nationals or residents”).

\textsuperscript{316} Id. § 416 cmt. a.

\textsuperscript{317} Under the Restatement, it would be reasonable for the United States to exercise jurisdiction based on representations made in the United States and for the protection of a U.S. investor. See id. § 416(2)(b)-(c), cmt. a. This is not to say that the application of foreign law would be inappropriate. As in blue sky law, the transaction may have sufficient connection to both U.S. and foreign law to warrant application of either law. See Joseph C. Long, 12 BLUE SKY LAW § 4.1 (2010).
The Long Road to Integrating Public Health into Sustainable Development of Shared Freshwaters in International Environmental Law: Lessons from Lake Victoria in East Africa

WILLIAM ONZIVU*

Abstract

The health dimension of sustainable development and its limits in optimizing health protection has led to a rethinking of the management of shared water resources in international environmental law. This paper discusses human health in the sustainable development of shared waters and its limits using a case study of the sustainable management of the Lake Victoria Basin. It links the public health challenges to the strengths and limitations of the global, East African, and domestic legal regimes for sustainability and environmental governance. The quest to integrate health concerns in the sustainable management of Lake Victoria faces challenges. The substantive legal regimes for tackling health issues and governance mechanisms are weak, fragmented, and ineffective in a framework of adaptive governance. This paper calls for enhanced collaboration among the actors and the reinvigoration of regional and domestic governance mechanisms to promote human health and the environment in the basin.

I. International Environmental Law, Health, and Sustainable Management of Shared Freshwater Resources

A. PROLOGUE: THE CRUX OF THE PROBLEM

International water law has focused largely on the allocation of water quantity and less on the quality and health issues facing water management. But its progressive development, as influenced by international environmental law, has been refocused on addressing

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quality and social concerns related to water management by the integration of sustainable
development in the pre-existing legal regimes for water. The health dimension of sustain-
able development has led to a rethinking of the management of shared water resources,
and the case of Lake Victoria demonstrates this. Attempts to integrate health concerns
into the sustainable management of Lake Victoria face challenges because the substantive
legal regime for tackling health issues and its implementation has been weak.

This paper argues for reinvigorating the centrality of health in sustainable environmen-
tal management of shared water resources. Health, environment, and natural resources
are interdependent and key aspects of sustainable development.1 Man-made and natural
capital (i.e., health, flora, and fauna) complement each other.2 As a result, new tools for
sustainable health and safety risk assessment integrate human health, ecosystem integrity,
and economic concerns.3 The Rio Declaration reflects the shift towards an anthropocen-
tric approach to environmental law, declaring that “human beings are at the centre of
concerns for sustainable development.”4 International human rights law also recognizes
the right to a healthy environment, culminating in the recent adoption by the U.N. Gen-
eral Assembly of the human right to water and sanitation.5 Several global and regional
legal instruments incorporate sustainable development. But it is argued that the social
pillar of sustainability, which includes health, is not firmly embedded in sustainable develop-
ment law, despite this concept promoting human health. On the other hand, these
instruments have not effectively integrated or implemented health protection. The legal
regime for sustainable management of Lake Victoria (Lake) reflects this trend.

This paper is comprised of six parts. Part I focuses on the problematic posits of human
health in international environmental law and policy. Part II provides an overview of the
environmental health crisis facing the Lake Victoria Basin (Basin) in a global context. Part
III presents applicable international law relating to sustainable development, examining its
health protection potential in the context of water resource management. Part IV exam-
ines the East African community’s legal regime for the governance of Lake Victoria in
international and comparative legal contexts. Part V is a critique of the health and sus-
tainability of the governance mechanisms for the Basin. Part VI provides conclusions and
considers the implications for policy development.

B. HEALTH, SUSTAINABILITY, AND THE BRIDGING OF THE ANTHROPOCENTRIC AND
ECO-CENTRIC DIVIDE

A key objective of international environmental law is the protection of human health,
which communicates its deep concern for the relationship between human health and

1. See Edward P. Richards, The Role of Medical and Public Health Services in Sustainable Development, 32
2. See Herman E. Daly, On Wilfred Beckerman’s Critique of Sustainable Development, 4 ENVTL. VALUES 49,
3. See Michael D Mehta, Risk Assessment and Sustainable Development: Towards a Concept of Sustainable Risk,
8 RISK 137, 137 (1997).
environmental protection. In this relationship, sustainable development, which is defined as “development that meets the needs of the present without compromising the ability of future generations to meet their own needs,” helps to integrate this relationship. Health is human capital essential to sustaining the environment for future generations, and it helps refocus sustainability to advance human well-being. Scholars have established three stages in the development of environmental law. First, self-interest of the present generation is anthropocentric, focusing on resource exploitation and protection from pollution. The second stage adds a duty on the present and future generations to preserve our planet. The third stage is the emergence of a non-anthropocentric paradigm with nature itself possessing intrinsic rights in environmental law. In this third stage, the primary concern of environmental law is ecological survival, rather than solely human development and needs. It focuses on the duties of humans toward nature and on the inherent rights of nature. But while many countries “purport to grant their citizens a constitutional ‘right’ to a healthy environment,” courts often construe the right narrowly, focusing on environmental threats to human health. There is a general agreement among scholars that these stages overlap and are not clear-cut. This paper argues that health bridges the anthropocentric and eco-centric divide, as both human health and the natural environment are harmed by degradation from human activity. This reflects scholarly thinking that places health at the core of environmental justice and the duty incumbent upon the present generations towards future generations.

Emerging human rights jurisprudence and treaty law demonstrate a gradual move towards convergence of human and environmental rights. The 1981 African Charter on Human and Peoples Rights (Charter), a major regional human rights treaty, proclaims environmental rights broadly, equally protecting the right of all peoples to the “best attainable state of physical and mental health” and to “a general satisfactory environment.” In Social and Economic Rights Action Centre v. Nigeria (Ogoniland case of 2001),

10. Id. at 552.
11. See Antonio D’Amato, Do We Owe a Duty to Future Generations to Preserve the Global Environment?, 84 Am. J. Int’l L. 190, 190 (1990).
12. Emmenegger & Tschentscher, supra note 9, at 568-576.
14. Emmenegger & Tschentscher, supra note 9, at 572-76.
19. Id. art. 24.

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the African Commission on Human and Peoples Rights, the institution that spearheads the implementation of the Charter, concluded that “an environment degraded by pollution and defaced by the destruction of all beauty and variety is contrary to satisfactory living conditions and development as the breakdown of the fundamental ecologic equilibria is harmful to physical and moral health.”\(^\text{21}\) It held that Article 24 of the Charter imposes an obligation on the state to take reasonable measures “to prevent pollution and ecological degradation, to promote conservation, and to secure ecologically sustainable development and use of natural resources.”\(^\text{22}\)

The *Ogoniland* case is a landmark, calling for comprehensive cleanup of lands and rivers damaged by oil operations, environmental and social impact assessments, provision of information on health and environmental risks, and access to regulatory and decision-making bodies.\(^\text{23}\) The case integrates “environmental protection, economic development, and guarantees of human rights,” affirming the unity of the environmental, social, and economic pillars of sustainable development.\(^\text{24}\) Similarly, in the case of *Marangopoulos vs. Greece*, the European Committee of Social Rights held that the right to health also embodies a right to a healthy environment.\(^\text{25}\) The two cases demonstrate the bridging of the eco-centric and anthropocentric divide and how health provides an important element in that linkage. In the 1950s, Mark D. Hollis argued that the foundations of environmental health rest on the essentials of “man’s need for and man’s use of air, water, food, and shelter.”\(^\text{26}\) He further argued that the common aspect of this foundation is sanitation and health, which are universal and common necessities to all peoples.\(^\text{27}\) A health perspective of sustainable development provides an important basis for examining the sustainability crisis facing Lake Victoria.

II. The Environmental Health and Sustainability Crisis in the Lake Victoria Basin

A. The Global Health Trends

Health is affected to a great measure by environmental conditions. The World Health Organization (WHO) defines environmental health as “the direct pathological effects of chemicals, radiation and some biological agents, and the effects (often indirect) on the health and [well-being] of the broad physical, psychological, social and aesthetic environment.”\(^\text{28}\) This reflects the WHO constitutional definition of health as “a state of complete

\(^\text{21}\) Id. ¶ 51.
\(^\text{22}\) Id. ¶ 52.
\(^\text{27}\) Id.
physical, mental and social well-being and not merely the absence of disease or infirmity. This also reflects health as psychosocial and physical, “encompassing the continuum between [being] healthy and not healthy,” as well as acknowledging that humans are living beings who exist in social environments. Furthermore, there is a direct correlation between availability of freshwater and human health. Diarrheal diseases, which are largely preventable through access to safe drinking water and sanitation, continue to kill children. Global estimates of child deaths due to diarrhea amount to 2.5 million annually, even though a recent estimate put the figure at 1.87 million deaths each year. It is estimated that 22 percent of all deaths among children under five years old in sub-Saharan Africa, and 23 percent in south Asia, were caused by diarrheal diseases in the year 2000. Freshwater is essential to the survival of humans, flora, and fauna, and it is dwindling globally. A report of the WHO and the United Nations International Children’s Emergency Fund (UNICEF) details the inter-linkages between the lack of water and rapid population growth. The report states that about 1.1 billion people lack access to clean water and that 2.4 billion lack sanitation facilities. The U.N. General Assembly’s recent Declaration recognized a human right to water and sanitation, which demonstrates its resolve to tackle the global water and sanitation crisis.

B. The Evolving Public Health Disaster in the Lake Victoria Basin

Lake Victoria is shared between Kenya, Uganda, and Tanzania. Its catchment of the principal affluent river Kagera runs through Rwanda and Burundi. The Nile River outflow is an extremely important freshwater resource for the Basin countries of Uganda,

31. See generally Maggie A. Montgomery & Menachem Elimelech, Water and Sanitation in Developing Countries: Including Health in the Equation, 41 ENVTL. SCI. & TECH. 17, 17 (2007).
34. Cynthia Boschi-Pinto, Lana Velebit & Kenji Shibuya, Estimating Child Mortality Due to Diarrhoea in Developing Countries, 86 BULL. WHO 710, 710 (2008).
38. Id.
39. See G.A. Res. 64/292, supra note 5, ¶ 1.
Sudan, Ethiopia, and Egypt. “With an estimated population of 35 million people, the Lake Victoria Basin supports one of the densest and poorest populations in sub-Saharan Africa,” if not the world. This is compounded by public health threats of HIV/AIDS and malaria, unplanned urbanization, and environmental degradation. For example, research by Uganda’s Medical Research Foundation found that HIV/AIDS prevalence rates among fishermen on the landing sites around Lake Victoria are between 28 to 30 percent, considerably above Uganda’s national average of 6 percent. The reduction of the water level of Lake Victoria, due to human activity and climate change, has also increased the prevalence of mosquitoes and malaria. Water pollution, alongside HIV/AIDS and malaria, is a major cause of mortality of children in the Basin. Lake Victoria is under pressure from human activities, including destructive fishing, pollution, and erosion of deforested watersheds. The sources of pollution include untreated human and animal waste, which threaten both human health and the ecosystem. Water pollution is a public health problem. Waste pollution contributes to poor water quality and disease in lake-side communities. This poses a major risk to public health because 70 percent of the Basin population utilizes untreated water. Contamination of drinking water results from poor sanitation, hygiene, and poor floodwater management. Water-borne diseases associated with contaminated water and poor sanitation—including typhoid fever, cholera, dysentery, and malaria—reduce life expectancy in the Basin. A general lack of awareness
of good hygiene practices, contamination of beach waters through bathing and washing, and uncontrolled waste disposal around the shoreline have led to low standards of health in the Basin.\textsuperscript{53}

C. Urban Pollution and Eutrophication

Lake Victoria has undergone enormous environmental changes in the recent past.\textsuperscript{54} For Example, overfishing, degraded watersheds, industrial pollution, and climate change are threatening its ecosystem diversity.\textsuperscript{55} The Basin faces complex social, economic, political, and technical barriers.\textsuperscript{56} An environmental impact assessment of the Lake identified overfishing and pollution of the Lake as threatening both the environment and human health.\textsuperscript{57} Within the Basin, untreated effluent is discharged into feeder-rivers and lakes.\textsuperscript{58} The number of people without sewers in urban populations around the Lake is high and worsening.\textsuperscript{59} Microbiological pollution occurs because, while treatment works in municipalities, investment in waste management and enforcement of municipal by-laws are inadequate.\textsuperscript{60}

Another great threat facing Lake Victoria is eutrophication, the response of ecosystems to increases in nutrient loads.\textsuperscript{61} Eutrophication is caused by effluent, sedimentation, and large-scale farming and industrial production in East Africa.\textsuperscript{62} Increases in human populations, urbanization, agriculture, and demand for land have led to encroachment of wetlands around the Lake.\textsuperscript{63} Poor monitoring and enforcement of regulations,\textsuperscript{64} unsustainable land-use practices,\textsuperscript{65} forest burning, and soil erosion aggravate eutrophication.\textsuperscript{66} Chemical pollution due to effluent, industrial discharge, pesticides, medical, oil, and}

\textsuperscript{53. Regional Assessment 47, supra note 52, at 47-52.}
\textsuperscript{55. See Eric Onyango Odada et al., Environmental Assessment of East African Rift Valley Lakes, 65 AQUATIC SCI. 254, 255 (2003).}
\textsuperscript{56. See Alfred Duda, Restoring and Protecting the African Great Lake Basin Ecosystems – Lessons From the North American Great Lakes and the GEF, in THE EAST AFRICAN GREAT LAKES, supra note 51, at 537, 539.}
\textsuperscript{57. See generally Odada, supra note 55.}
\textsuperscript{60. Oyoo, supra note 59, at 1.}
\textsuperscript{61. See P.A.G.M. Scheren et al., Estimation of Water Pollution Sources in Lake Victoria, East Africa: Application and Elaboration of the Rapid Assessment Methodology, 58 J. ENVTL. MGMT. 234, 236 (2000).}
\textsuperscript{62. See id.}
\textsuperscript{64. Id. at 120.}
\textsuperscript{65. Scheren et al., supra note 61, at 245.}
\textsuperscript{66. See Harvey A. Bootsma & Robert E. Hecky, Conservation of the African Great Lakes: A Limnological Perspective, 7 CONSERVATION BIOLOGY 644, 644 (1993).}
and other banned substances poses a severe threat to human health.\textsuperscript{67} In Uganda, expired chemicals, drugs, and partially treated domestic sewage from Kampala are often dumped into waterways that flow into Lake Victoria.\textsuperscript{68} Most industries in the Basin are located in the large towns bordering the lakes: Kampala and Jinja in Uganda, Mwanza and Musoma in Tanzania, and Kisumu in Kenya.\textsuperscript{69} In these cities, the urban and semi-urban growth is rapid and largely unplanned, and municipal authorities poorly manage waste disposal, which ends up in Lake Victoria.\textsuperscript{70} A 2010 report by Uganda’s National Environment Management Authority (NEMA) identified the ten worst polluters in Kampala that endangered the Basin ecosystem and public health.\textsuperscript{71} They included the private fishing, beverage, and meat industries around Entebbe, Jinja, and Kampala.\textsuperscript{72}

III. Health and the Evolution of International Sustainable Development Law

A. The Three Pillars of Sustainable Development: From Stockholm to Johannesburg

1. Origin and Evolution

Sustainable development is comprised of three pillars: environmental, economic, and social.\textsuperscript{73} The social pillar includes poverty eradication, access to water and sanitation, health, labor standards, and human rights.\textsuperscript{74} It is argued that the social pillar, where health is situated, has been marginalized in sustainable development law and policy. Several global sustainable development instruments that include health have emphasized the economic over the environmental and the social pillar.\textsuperscript{75} For instance, the 1972 United Nations Conference on Human Environment recognized health concerns in global environmental problems.\textsuperscript{76} Similarly, the Rio Declaration placed human beings at the center of sustainable development, in harmony with nature, laying down a framework for equal

\textsuperscript{68} Id. at 365.
\textsuperscript{69} Scheren et al., supra note 61, at 239.
\textsuperscript{72} Id.
\textsuperscript{73} Robert W. Kates et al., What is Sustainable Development? Goals, Indicators, Values, and Practice, 47 Env’t: Sci. & Pol’y for Sustainable Dev. 8, 12 (2005).
\textsuperscript{76} Id. ¶ 3.
operationalization of the three pillars. Agenda 21 from the Rio Conference provided for the protection of health, especially primary healthcare. By emphasizing both preventive health strategies and sustainable development, Agenda 21 integrated health and the social pillar into sustainable development. It also energized the health sector as a core actor in shaping international environmental law and policy. But the environmental pillar that was emphasized in Stockholm was rebalanced in 1992 by the Rio Declaration, which declared human beings to be “the central concern of sustainable development” and “entitled to a healthy and productive life in harmony with nature.”

The Johannesburg World Summit on Sustainable Development in 2002, which placed health as a priority, brought further efforts to reinvigorate the social pillar. A number of health-related objectives enshrined in the Millennium Development Goals were adopted to encourage states to increase access to sanitation and clean water to improve child health. It called upon parties “to reduce respiratory diseases and other health impacts resulting from air pollution.” The Summit called for significant reduction by 2020 of the adverse effects to human health and the environment caused by the use and production of chemicals. It reaffirmed the commitment to fund the Global Fund to Fight AIDS, Tuberculosis, and Malaria, but no additional funding was committed. The pronouncement on the importance of human rights in the provision of healthcare and preventive health services confirmed health as a key aspect of sustainable development. But the Johannesburg Summit added nothing substantially innovative to reinforce the social pillar. No new treaties and few targets from lower profile meetings were agreed. Nonetheless, the summit elevated the significance of health within the social pillar.

2. The Legal Status of Sustainable Development Principles in International Law

An emerging body of principles relating to sustainable development reconciles economic, environmental, and social legal regimes. It is also the case that international

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77. See generally Rio Declaration, supra note 4.
78. See Agenda 21, supra note 74, ¶¶ 6.4, 6.27.
79. Id.
80. Id.
82. Rio Declaration, supra note 4, princ. 1; Boyle, supra note 23, at 473.
83. VED P. NANDA & GEORGE W. PRING, INTERNATIONAL ENVIRONMENTAL LAW FOR THE 21ST CENTURY 17-62, 116 (2003); Johannesburg Summit
84. Plan of Implementation, supra note 74, ¶ 23.
85. Id. ¶ 32.
86. Id. ¶ 56.
88. Plan of Implementation, supra note 74, ¶ 56.
89. NANDA & PRING, supra note 83, at 113.
91. NANDA & PRING, supra note 83, at 119.
sustainable development law constrains the social pillar.\textsuperscript{94} Sustainable development has achieved normative character in international law,\textsuperscript{95} assigning rights and obligations and facilitating interpretation.\textsuperscript{95} It finds support in the case concerning Gabčíkovo-Nagymaros Project between Hungary and Slovakia (Gabčíkovo case), where Judge Weeramantry identified the general acceptance of sustainable development principles by the global community.\textsuperscript{96} Several global and regional legal instruments provide for sustainable development,\textsuperscript{97} such as the Protocol on Sustainable Development of Lake Victoria.\textsuperscript{98} It is an emerging area of international law in its own right, integrating environmental, economic, and social law for sustainability.\textsuperscript{99} Sustainable development helps to curb the worst social and environmental impacts of economic activities and requires a balancing of the economic, environmental, and social pillars.\textsuperscript{100} Yet its legal status remains fluid. Alan Boyle argues that [n]ormative uncertainty, coupled with absence of justiciable standards for review, strongly suggest that there is "no international legal obligation to develop sustainably."\textsuperscript{101} Boyle further opines that decisions on what constitutes sustainability rest primarily with individual governments."\textsuperscript{102} Vaughan Lowe argues that sustainable development as a norm of customary international law is unsustainable.\textsuperscript{103} Without a strong legal status, it is a challenge to achieve health protection in the context of sustainability. This lack of consensus is relevant to the subsequent discussion on Lake Victoria.

B. HEALTH, SUSTAINABLE DEVELOPMENT, AND SHARED WATER RESOURCES: THE GLOBAL LEGAL REGIME

Water protects health through food and nutrition and the maintenance of a healthy environment but can harm health through waterborne diseases.\textsuperscript{104} Hence, international water law is pivotal for health protection. This link has been recognized in Europe by the adoption of the Protocol on Water and Health to the Convention on the Protection and

\textsuperscript{95} SEGGER & KHALFAN, supra note 93, at 97.
\textsuperscript{96} Gabčíkovo-Nagymaros Project (Hung. v. Slovk.), 1997 I.C.J. 7, 78 (Sept. 25).
\textsuperscript{97} SEGGER & KHALFAN, supra note 93, at 46; see NICOS SCHRIJVER & FRIEDL. WEISS, INTERNATIONAL LAW AND SUSTAINABLE DEVELOPMENT: PRINCIPLES AND PRACTICE (2004).
\textsuperscript{100} MICHAEL DECLERS, THE LAW OF SUSTAINABLE DEVELOPMENT: GENERAL PRINCIPLES, A REPORT PRODUCED FOR THE EUROPEAN COMM.
\textsuperscript{101} Alan Boyle, Introduction, in INTERNATIONAL LAW AND SUSTAINABLE DEVELOPMENT: PAST ACHIEVEMENTS AND FUTURE CHALLENGES 1, 16 (Alan Boyle & David Freestone, eds., 1999).
\textsuperscript{102} Id.
\textsuperscript{103} Vaughan Lowe, Sustainable Development and Unsustainable Arguments, in INTERNATIONAL LAW AND SUSTAINABLE DEVELOPMENT, supra note 101, at 19, 30.
Use of Transboundary Watercourses and International Lakes.\(^{105}\) The Protocol aims to protect human health through better water management, the protection of water ecosystems, and preventing and reducing waterborne diseases.\(^ {106}\) The legal regime of internationally shared water resources is evolving, especially regarding water quality.

Four international legal principles underpin the management of shared water resources. First, absolute territorial sovereignty grants states the unlimited right to exploit the resources within their territory.\(^ {107}\) Second, absolute territorial integrity provides that no action of another state shall have influence on the territory of another.\(^ {108}\) Third, the concept of limited territorial sovereignty and integrity attempts to reconcile the freedom of use of water resources with the right to freedom from unwanted interferences to the water resource,\(^ {109}\) and it establishes the equality of the rights of each riparian state to an international watercourse.\(^ {110}\) It imposes an obligation to manage shared water and not to interfere with use by other riparian States.\(^ {111}\) Finally, the doctrine of community of interests provides that parties of a shared river have a community of interests in the use of a river, as was held in the River Oder Case\(^ {112}\) and expanded in the Gabcíkovo case.\(^ {113}\) The doctrine includes the common heritage of mankind\(^ {114}\) and common concern for mankind.\(^ {115}\) The key rule of universal application is that only riparian states have a legal right to use shared waters, in absence of their consent.\(^ {116}\)

A number of international legal regimes provide for management of shared waters.\(^ {117}\) The U.N. Convention on the Law of the Non-Navigational Uses of International Watercourses\(^ {118}\) reinforces the legal principles of equitable, reasonable utilization\(^ {119}\) and the


108. Id. at 126.

109. Id., at 135.


115. Id.


119. Id. arts. 5-6.
obligation to prevent causing significant harm to other watercourse states.120 The protection of public health is one of the requirements under the UN Convention even though it is constrained by it.121

The protection of public health is one of the requirements under the UN Convention even though it is constrained by it.

The Helsinki Rules form a body of customary international law requiring Basin States to prevent pollution.122 Water pollution is defined as “any detrimental change resulting from human conduct in the natural composition, content, or quality of the waters of an international drainage basin.”123 This provision is a restatement of the obligation of states not to cause serious harm to another, such as through pollution.124 But a careful review of the global water legal regimes demonstrates their preoccupation with allocation of water quantity and lesser emphasis on health protection concerns. The evolving state of global water law, such as that for the management of Lake Victoria, provides an incoherent point of reference for regional regimes that seek to address major public health issues. This lacuna accentuates the health deficit at the regional level, such as in East Africa where the sustainability regime is undermined by the existing global legal regimes for the management of shared waters.

C. Health, Sustainable Development, and Regionalism: Limits and Prospects

Regional law and policy making presents an important framework for environmental and health governance. Regional policies and programs can be oriented and implemented to respond to local conditions, needs, and priorities. Regional regimes are evolving as drivers of policy and action in environmental health.125 Regionalism promotes sustainable development by integrating environmental and social policies into trade and economic accords and their general governance mechanisms.126 Regional approaches can succeed if they have effective mechanisms for collective experimentation and sharing experiences. Geographical proximity enables rapid diffusion of practices, promoting adaptation to new conditions. As in the European Union, regionalism can promote crystallization of environmental health standards127 and can translate international commitments to the national level.128 It may implement regional sustainability priorities,129 enhance environmental co-

120. Id. art. 7.
121. Id. art. 21(2).
122. Campione Consolidation, supra note 117, art. 10.
123. Id. art. 13.
128. Onzivu, supra note 126, at 112.
operation,\textsuperscript{130} build capacity, and monitor and enforce environmental policy.\textsuperscript{131} For example, in the African context, the African Union has developed a progressive environmental policy culminating in the adoption in 2003 of the African Convention on the Conservation of Nature and Natural Resources.\textsuperscript{132} Its Member States committed to accelerating the achievement of water and sanitation goals at their Eleventh Ordinary Session of the Assembly in Sharm El-Sheikh in July 2008.\textsuperscript{133} They recognized “the importance of water and sanitation for social, economic, and environmental development” and committed themselves to “promot[ing] integrated management and development, of national and shared water resources in Africa.”\textsuperscript{134} Regional Economic Communities (RECs), such as the East African Community (EAC), were encouraged to spearhead this agenda in their development planning to ensure that trans-boundary natural resources are protected and utilized in an equitable and sustainable manner. Unfortunately, the African Union has been ambitious, but ineffective, because environmental protection has not been accorded the priority it deserves.

IV. Health and Governance of Sustainable Development in the Case of Lake Victoria: The Legal Regime

A. Applicable Legal Regime of the East African Community

The principal legal instrument for the EAC is the Treaty for the Establishment of the East African Community.\textsuperscript{135} It was signed on November 30, 1999 and entered into force on July 7, 2000, heralding the rebirth of the EAC as a major regional economic integration bloc.\textsuperscript{136} The objectives of the community [are] to develop policies and [programs] aimed at widening and deepening [cooperation] among the Partner States in political,

\textsuperscript{133} African Union, Sharm El-Sheikh Commitments for Accelerating the Achievement of Water and Sanitation Goals in Africa, Assembly/AU/Decl. 1(XI), 11th Ordinary Sess., at 1 (June 30-July 1, 2008).
\textsuperscript{134} Id. at 1, 3.
\textsuperscript{136} Id. art. 153.
economic, social[,] and other fields . . . .”137 The Treaty envisages the development of programs and policies in diverse areas, including the environmental and health fields.138 Article 5(3) stipulates that:

[T]he community shall ensure . . . the attainment of sustainable growth and development of the Partner States by the promotion of a more balanced and harmonious development of the Partner States . . . the promotion of sustainable utilization of the natural resources of the Partner States and the taking of measures that would effectively protect the natural environment of the Partner States.139

The Treaty contains substantive provisions addressing the environment, natural resource management, tourism, and wildlife management.140 It provides for joint management and utilization of natural resources within the EAC for the mutual benefit of partner States.141 The Treaty also provides for the joint development and adoption of harmonized common policies and strategies for sustainable management of trans-boundary natural resources within the EAC.142 With regard to shared waters, community action is required to “ensure sustainable [utilization] of natural resources like lakes, wetlands, forests and other aquatic and terrestrial ecosystems; and to jointly develop and adopt water resources conservation and management policies that ensure sustenance and preservation of ecosystems.”143 The Treaty also aims to promote cooperation on health matters among Community Partner States.144 The Partner States are required to undertake “joint action towards the prevention and control of communicable and non-communicable diseases and . . . pandemics” and epidemics including “vector-borne diseases such as HIV-AIDS, cholera, [and] malaria.”145

The EAC has developed two protocols on environmental management: the Protocol for the Sustainable Development of Lake Victoria146 and the Protocol on Environment and Natural Resources Management.147 The Third EAC Development Strategy (2006-2010) (Policy) established “sustainable environmental management and economic utilization of natural resources” as a development objective.148 The Policy identified other strategic interventions, including the preparation of a common water vision and establishment of an East African Water Management Institute.149 The Policy identifies the environmental management of Lake Victoria, combating of HIV/AIDS, and other health threats such

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137. Id. art. 5(1).
138. Id. chs. 19, 21.
139. Id. art. 5(3)(a), (c).
140. Id. arts. 111-16.
141. Id. art. 111.
142. Id. art. 114.
143. Id. art. 111(2)(c)-(d).
144. Id. art. 117.
145. Id. art. 118.
149. Id. at 44.
as cross-cutting interventions and sectoral objectives.\textsuperscript{150} Taken together with relevant international instruments on sustainable development, water, and health to which the East Africa Partner States are parties, the regional instruments provide the legal framework for the sustainable management of Lake Victoria.

B. The Protocol on Environment and Natural Resources Management

The Protocol on Environment and Natural Resources Management was adopted by the EAC in 2005.\textsuperscript{151} It provides for cooperation in environment and natural resources management\textsuperscript{152} and promotes sustainable use and management of environmental and natural resources.\textsuperscript{153} EAC States are required to “develop, [harmonize] and adopt common national policies, laws and [programs] relating to the management and sustainable use of water resources” and to utilize water resources in an equitable and rational manner.\textsuperscript{154} The Protocol is not yet operational, but it embodies the common vision of the EAC on environmental issues.\textsuperscript{155} The Protocol highlights the importance of collaborative management of the environment and natural resources in the Community.\textsuperscript{156} The scope of the Protocol is biased towards the economic and environmental pillars because of the absence of health-specific requirements.\textsuperscript{157}

The Protocol also affirmed the commitment of the Partner States to cooperate and to uphold the principle of sustainable development.\textsuperscript{158} The Partner States agreed to cooperate in environment and natural resources management through the development of common policies and the coordination of actions to protect the environment and natural resources.\textsuperscript{159} They committed to ensure that development activities are based on sound environmental policies that do not have adverse impacts on natural resources and the environment.\textsuperscript{160} They also agreed to take all measures conducive to sustainable development, to tackle poverty in East Africa, and to protect the environment and natural resources.\textsuperscript{161} Partner States are required to “take appropriate measures . . . including the adoption of laws and regulations, administrative actions and enforcement measures” to comply with the Protocol.\textsuperscript{162} Partner States commit to refrain from activities that undermine the effectiveness of the Protocol.\textsuperscript{163} The EAC adopted the Regional Environment

\begin{thebibliography}{99}
\addcontentsline{toc}{section}{References}
\bibitem{150} Id. at 36, 39, 41, 50.
\bibitem{151} Protocol on Environment and Natural Resources Management, supra note 147, pmbl., art. 51.
\bibitem{152} Id. ch. 3.
\bibitem{153} Id. art. 40.
\bibitem{154} Id. art. 13(1)-(2).
\bibitem{155} See id.
\bibitem{156} Id. art. 2.
\bibitem{157} See id. art. 3.
\bibitem{158} See id. ch. 2.
\bibitem{159} Id. art. 7(1)(a), (c).
\bibitem{160} Id. art. 8(1), (2)(b)-(c).
\bibitem{161} Id. art. 8(2)(d).
\bibitem{162} Id. art. 40(1).
\bibitem{163} See id. art. 43(2).
\end{thebibliography}
Impact Assessment Guidelines for shared ecosystems in 2005. It focuses on ecosystems and only peripherally on public health.

C. Protocol on Sustainable Development of Lake Victoria Basin

The Protocol on Sustainable Development of Lake Victoria Basin was signed by the Partner States of the EAC. The Protocol addresses environmental concerns in and around Lake Victoria and requires Members’ cooperation on sustainable development, management, equitable utilization of water resources and “improvement in public health with specific reference to sanitation.” The Protocol establishes the Lake Victoria Basin Commission for the sustainable management of the Lake Victoria Basin. It is mandated with a broad range of functions, including guiding implementation of sectoral projects and programs and promoting capacity building and institutional development, especially poverty eradication. A key principle of the Protocol is the “prevention, minimization and control of pollution of watercourses so as to minimize adverse effects on fresh water resources and human health.” While the ecosystem-human health balance is a key objective of the Protocol, the detailed steps prescribed to achieve this balance are biased towards ecosystem protection, with ambivalence on health issues. Reminiscent of the common fragmentation of international legal regimes and lack of issue linkages, a major challenge of the Protocol on Sustainable Governance of Lake Victoria is the lack of integration of global public health standards in its sustainability legal regime.

D. Institutional Frameworks for Sustainability in the East African Community

The Council of Ministers is the EAC policy organ responsible for developing and adopting regional environmental policy. The implementation of Council decisions is the responsibility of the EAC secretariat, who also oversees national environmental focal points like the National Environment Management Authorities of Uganda and Kenya, the Rwanda Environment Management Authority, the Department of Environment in the

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165. See id. ¶ 1.1 (health is only mentioned once in the definition of Environmental Impact Assessment). See id.
167. Id. arts. 7-9.
168. Id. arts. 5-6.
169. Id. art. 5(6).
170. Id. art. 33(1).
171. Id. art. 33(3)(c)-(d), (j).
172. Id. art. 4(2)(6).
173. See id. art. 6(1).
Vice President’s Office and National Environmental Management Council of Tanzania, and the Department of Land and Environmental Management in Burundi. Community organs such as the East Africa Legislative Assembly (EALA) and the East African Court of Justice (EACJ) also contribute to environmental and health policy.177 “The sectoral Committee on Environment and Natural Resources is comprised of senior officials from the Partner States from the Ministries Responsible for Water, Fisheries, Environment, Forests, Minerals and Wildlife issues.”178 Four working groups support the Sectoral Committee: the Terrestrial Ecosystems, Aquatic Ecosystems, Pollution Issues and Policy, and the Legal and Institutional Frameworks.179 A specific health-working group should enhance the link between health and environment, and its absence places health in a policy limbo. The EAC has a health desk, but cross-coordination and integration with other sectoral working groups or the commission on the sustainable use of Lake Victoria faces challenges.180

“The EAC secretariat is the executive organ for the East African Community . . . and provides a forum for Partner States to harmonize their laws, policies and standards.”181 The Lake Victoria Basin Commission (LVBC), based in Kisumu, Kenya, is a specialized institution of the EAC that spearheads the “sustainable development and management of natural resources of the Lake Victoria Basin.”182 The Lake Victoria Fisheries Organization (LVFO) based in Jinja, Uganda, provides leadership to harmonize national measures for sustainable use, conservation, and management of the lake’s fisheries resources.183

E. The East African Legal Regime and International Sustainable Development Law, a Comparative Synopsis

The U.N. Convention on the Law of the Non-Navigational Uses of International Watercourses184 incorporates the concepts of sustainable utilization185 and sustainable development186 as overarching principles in the management of shared water resources. Watercourse States are required to cooperate to tackle pollution.187 Like relevant global and regional instruments, the East African legal frameworks do not sufficiently advance the social pillar of sustainable development relative to the economic and, to a lesser extent, the environmental pillar to deal with health issues effectively. The East African legal regime builds on the basic international sustainable development standards in the 1997

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178. Id.

179. See id.


181. See Institutional Framework with Regard to EAC Watershed Governance Structure, supra note 177.

182. Id.

183. Id.


185. Id. pmbl., art. 5(1).

186. Id. art. 2(2)(a).

187. Id. art. 21(2)-(3).
Convention on the Law of the Non-Navigational Uses of International Watercourses, but does not comprehensively address health. This can be contrasted with regional legal regimes that provide a stronger legal foundation for integrating health issues in the management of shared watercourses. First, the European nations have adopted a regional Protocol on Water and Health to the Convention on the Protection and Use of Transboundary Watercourses and International Lakes. Second, the 2002 Senegal River Water Charter recognizes the principles of both sustainable development and the human right to water even though health is not expressly mentioned. Third, the Tripartite Interim Agreement for Co-operation on the Protection and Sustainable Utilization of the Water Resources of the Incomati and Maputo Watercourses emphasizes the importance of both sustainable development and environmental impact assessment for both environmental and human health.

V. A Health and Sustainability Critique of Governance of the Lake Victoria Basin

The key challenges to sustainable development in the region are high population, the attendant pressures from their interaction, and weak legal and institutional arrangements to regulate the pressures and to monitor compliance with applicable laws. This has resulted in overexploitation of fisheries, water pollution, poor waste disposal, and unsustainable management of the Lake. Water governance in the EAC is rooted in legal instruments restrictively focused on utilization and conservation of water. The five Partner States of the EAC have domestic water laws, but their legal effects are domestic and ineffective for regional management of shared ecosystems and public health. This weak governance of the Basin contributes to the challenges of integrating health concerns into its sustainable management, as discussed below.

A. Weak Governance of Sustainability and Focus on the Economic Pillar

The Partner States possess weak sustainable development strategies in fragmented policy instruments, and their implementation is problematic. This is demonstrated by the lack of fully functional, coherent, and decentralized strategies, institutional mechanisms, and capacity for implementation of regional sustainable development policies. The EAC

188. See id. arts. 19(1), 21(2).
193. See id.
195. See id.
governance mechanisms have not fostered effective synergies between poverty, health, and environmental protection. The EAC continues to face challenges in synergetic and collaborative interventions to promote health and the environment within its sustainability regime. The EAC’s laws and policies are biased towards market-oriented development, with inadequate mitigation of the environmental and health impacts of economic liberalization within the region. For example, the EAC’s environmental protocol is not in force. The focus on fast tracking a political federation has relegated environmental and public health issues to the margins. The Third EAC Development Strategy (2006-2010) identified sustainable environment management and economic utilization of natural resources as development objectives. But these have been overshadowed by the primacy of trade liberalization and economic development that reinforces the economic pillar over the environmental and health pillars of sustainability. Efforts to make Lake Victoria green often fail to effectively capture public health concerns. The national development plans of Partner States do not prioritize the health and sustainability challenges facing Lake Victoria. For example, in a bid to attract foreign private investments, Uganda’s fisheries policy has arguably prioritized big, private-sector fisheries over small-scale, community-based fishing. Yet big fishing companies in the Basin have been accused of unsustainable fishing practices and pollution of the Lake. In a 2010 report, two private fish companies, Uganda Fish Packers and Ngege Fish Factory, were among the top ten polluters in Uganda and Lake Victoria. In Kenya, some multinationals were accused of setting up activities in swamps; while in Tanzania, poverty reduction policies emphasize the primacy of the private sector over environmental and social development.

B. Weak Environmental Health Governance

The Protocol on Sustainable Development of Lake Victoria Basin requires Partner States to “create an environment conducive for stakeholders’ views to influence governmental decisions on project formulation and implementation.” Weak governance causes inequitable economic and social development of populations in the Basin and enables narrow national interests to trump broader EAC social objectives such as health.

198. See id. at 53.
200. See id. at 16.
204. See Tenywa, supra note 71, at 1.
205. See Bagumire et al., supra note 203, at 459.
207. See Kimani, supra note 197, at 46, 32.
Moreover, corruption, lack of accountability, and weak public financial management undermine effective participation of the public and civil society to promote environmental health in the Basin.\textsuperscript{208} International conventions to which the Partner States are parties have not been implemented to address the environmental health threats facing the Lake.\textsuperscript{209} Domestic public health laws impose standards on regulating clean water by monitoring water pollution from car washing, sewage systems, and flower farms, but these have not been effectively monitored. Nonexistent regional public health laws undermine pollution control efforts to protect the ecosystem and public health in the Basin.\textsuperscript{210} It is uncertain whether the recent establishment by the Lake Victoria Environment Management Commission of Public Health and Sanitation office will help advance health protection in the Basin.\textsuperscript{211} The EAC’s legal and policy frameworks, while seemingly elevated on environmental management, have actually constrained environmental and social pillars of sustainability in the region. For example, while one of the objectives of the Protocol for Sustainable Development of Lake Victoria Basin is health, there are no specific institutional and procedural mechanisms to realize them.\textsuperscript{212} States have detracted from domestic sustainability policies in a race to the bottom to attract economic investment without mitigating environmental and health damage.\textsuperscript{213} The lack of strategic and comprehensive action to address threats to the Lake exacerbates the problems.\textsuperscript{214} The absence of regular reviews of economic, social, and environmental legislation to achieve sustainability in the face of evolving challenges in the Basin undermines sustainable development. In Uganda, primary health and sanitation are devolved to local governments. But limited human and technical expertise, enforcement of public health and environmental laws and municipal bylaws, as well as insufficient involvement of local communities undermine protection of health in East Africa, including in the Basin.\textsuperscript{215}

C. SECTORAL AND POLICY FRAGMENTATION: REGIONAL AND DOMESTIC

While the EAC is endowed with a mandate to sustainably manage Lake Victoria, the governance regime remains sectorally fragmented. The EAC declared the Lake Victoria Basin an economic zone and entered into a partnership agreement with several donors such as the World Bank to fight poverty in the Basin.\textsuperscript{216} The initiative was aimed at

\begin{itemize}
\item \textsuperscript{209} See id. at 33.
\item \textsuperscript{210} See East African Community (EAC), Council Decision EAC/CM17/DC74, Lake Victoria Development on the Establishment of a Public Health and Sanitation Desk, Feb 27, 2009 (on file with the author).
\item \textsuperscript{211} See id. at 9-15.
\item \textsuperscript{212} East African Community (EAC), Council Decision EAC/CM17/DC74, Lake Victoria Development on the Establishment of a Public Health and Sanitation Desk, Feb 27, 2009 (on file with the author).
\item \textsuperscript{213} See Kimani, supra note 197, at 53.
\item \textsuperscript{214} See Report of the East African Regional Judicial Colloquium, supra note 192, at 12.
\item \textsuperscript{216} William Onzivu, Tackling the Public Health Impact of Climate Change: The Role of Domestic Environmental Health Governance in Developing Countries, 43 INT’L LAW. 1311, 1334-35 (2009).
\item \textsuperscript{217} Fredrick Jones Muyodi, Fredrick W.B. Bugenyi & Robert E. Hecky, Experiences and Lessons Learned from Interventions in the Lake Victoria Basin: The Case of Lake Victoria
\end{itemize}
addressing economic, social, and environmental issues in the Basin, but it did not specifically provide for health. The agreement led to a grant of over $75 million by the Global Environment Facility (GEF) to the East African Community under Phase One of Lake Victoria Environment Management Program that was completed in 2004.\footnote{217} The Phase One project was aimed, inter alia, “to supply safe water and sustain a disease-free environment.”\footnote{218} Ironically, a health project was not implemented.\footnote{219} Health was cursorily mentioned under general micro-projects for small communities. One would have thought that the omission of health in Lake Victoria Environmental Management Project Phase One would be comprehensively redressed in Phase Two of the project, but this has not been demonstrated in the Phase Two project objectives.\footnote{220} The Commission for Sustainable Management of Lake Victoria is the only EAC body that has recently done some minimal health work, conducting epidemiological surveys on HIV/AIDS with only one member of staff.\footnote{221}

Many EAC programs lack coordination with national and local basin initiatives.\footnote{222} Within regional initiatives, health concerns have not been addressed in an integrated manner.\footnote{223} “Data and information about Lake Victoria is biased towards academic research” and is without concrete operational plans for action.\footnote{224} Information systems and retention is weak and available data has not been strategically utilized to steer action in tackling the environmental and social problems facing the Basin.\footnote{225} Furthermore, corruption hampers effective regulatory reform in the water sector across the region.\footnote{226} Investments in water and sanitation infrastructure in the region are limited, yet unclear departmental responsibilities for water, sanitation, and sewage in Uganda and Kenya undermine effective intersectoral collaboration.\footnote{227} In urban areas, there are unclear responsibilities between local authorities (normally mandated for sanitation) and water utilities (normally mandated for sewerage).\footnote{228} In rural areas, unclear responsibilities between line ministries, such as those for water, health, fisheries, and environment, undermine strategic interventions across East Africa to manage the shared waters of Lake Victoria. The unclear lines of responsi-
bility undermine sectoral funding. There are no common water quality standards across the region where the role of the health sector would have been pivotal. Much of the pollution of the Lake emanates from cities around the Lake such as Kampala, Jinja, Kisumu, Mwanza, and Bukoba. Yet there are no harmonized national and city-specific bylaws relating to water, sanitation, and environmental health to support the Basin’s ecosystem and public health. This, in turn, undermines the integrated management of the Basin. It also undermines consistent monitoring of interventions for sustainability of the Basin.

D. WEAK DOMESTIC ENFORCEMENT AND COMPLIANCE REGIMES

In the face of the weak regional legal regime for health protection in the Lake Victoria Basin, recourse could be had through domestic water laws to protect health. Unfortunately, compliance with and enforcement of these laws are problematic. The Basin population in the three East African countries is uninformed about their water rights. For example, in Tanzania, the lack of an effective mechanism for disseminating information on water rights contributes to resentment and suspicion because some of the rural communities have very low literacy levels. Water rights and laws are written in English and are not translated into local languages such as Kiswahili, Luganda, or Luo, which undermines compliance and enforcement with water use laws by Lake communities. Government support and enforcement of existing legislation against improper natural resource use has been found to be weak in Kenya. Water ministries are centralized and do not involve local communities in planning, monitoring, or management of water resources. The sectoral nature of water management undermines the enforcement of water law because the allocation of responsibility for conserving water resources to several institutions creates procedural difficulties and because institutions often do not enforce law in the hope that other institutions will do so. Difficulty in enforcing laws and bylaws is also attributable to the lenient fines and penalties and a lack of enforcement resources by the water and other enforcement agencies. Furthermore, enforcement and compliance to protect water resources are complicated by competition between environment and other ministries for resources, technical assistance, and influence. Limited collaboration between environment, health, and the water departments undermines water quality enforcement and public health.

229. Id.
230. Id.
234. Id.
In the absence of an effective enforcement regime, a strong public health legal regime would be beneficial. But the Public Health Acts in the three East African countries, excepting Tanzania’s Public Health Act, were adopted in the colonial era and are obsolete. These laws cannot cope with modern health threats facing the region. There are public health policy commitments that could address water issues, but omissions or gaps in the laws are evident. For example, Uganda’s Public Health Act imposes a duty upon local authorities to maintain cleanliness and prevent nuisances. Nuisances are defined to include dirty wells or water sources, public or private, from which water is used or likely to be used by human beings for drinking or domestic purposes. All buildings must be constructed with sanitary conveniences and appropriate drainage facilities. Uganda’s Public Health Rules contain more detailed provisions on health and sanitation in rural areas. Latrines are to be sited at an appropriate distance from water sources. No person is permitted to pollute, damage, bathe, or wash in a spring, well, water-hole, dam, or at a place on a lake or river where the public draws water for domestic purposes. Animals are prohibited from getting into water used by the public for drinking or bathing, and a local administration is authorized to set aside special areas for drawing drinking water or for watering animals. Contravention of these rules attracts a fine or imprisonment. But the public health and sanitation laws have not been applied by the health and other enforcement agencies due to lack of personnel at the grassroots, logistical problems, and the low fines that are imposed.

E. Limited Capacity and Civil Society Participation

There are good and coordinated scientific technical capacities for fisheries management in the Basin, but less so for the ecological and health challenges facing the Basin. Mechanisms are lacking for the retention, exchange, or dissemination of scientific, technical, and legal information by governments, non-governmental organizations (NGOs), and communities on the Basin. Low public and private investment in sustainable development, onerous donor conditionality in official development assistance, and debt burdens on the Partner States inhibit their ability to equitably advance the three pillars of sustainability. This, in turn, undermines health protection in the Basin. Economic sectors such as mining and manufacturing have significantly expanded while social investments

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238. See id.
239. See id.
240. Id. at 14.
241. Id. at 29.
242. Id. at 14.
243. See id.
244. Id.
246. Id. § 57(i)-(k).
247. Id. § 35.
248. Lubovich, supra note 49.
remain under-resourced. Effective sustainability has been undermined by undue regulation of activities of civil societies by Partner States, as demonstrated by restrictive NGO laws being enacted in Uganda. Language barriers in the Basin also undermine community participation in sustainable development because many communities do not speak English or Kiswahili. Civil society and community participation in the Basin is more pronounced in the fisheries sector, with local communities self-enforcing regulations relating to overfishing or water hyacinth control, but is less so in addressing sanitation, diseases, and general pollution problems of the Basin. The East African Communities Organization for the Management of Lake Victoria (ECOVIC), an umbrella organization, has focused largely on environmental and poverty issues.249 There is a tendency for NGOs to participate during the life cycle of a donor project with no long-term plans to continue work when such projects are concluded. Public health is not a priority of these NGOs, and the few health NGOs are pre-occupied with diseases and other specific issues detached from the general public health threats facing the Lake.

VI. Proposals for Reform

Following the analysis of the limits of Lake Victoria’s sustainability legal regime for public health promotion and protection, a number of options for reform of the status quo are possible. The East African Community, its Member States, and other stakeholders need to adopt an effective adaptive governance framework for the Lake Victoria Basin. Adaptive governance institutions are those “capable of generating long-term, sustainable policy solutions” to complex and dynamic natural resource problems through collaboration among diverse resource users and governmental agencies.250 Governance is adaptable, extending adaptive management’s flexible, iterative approach beyond natural systems to human systems. Ideal adaptive governance reacts to challenges from both ecological and human institutions and systems.251 Adaptive management focuses on the interaction of resource management and science. It recognizes that, because science is constantly evolving, our understanding of natural systems or the effect of human interactions on these systems is rarely, if ever, complete.252 Scientific answers are social constructs, and instead of using science to predict outcomes far into the future and setting one-time static policies, adaptive management monitors outcomes and maintains flexibility so that policies can be altered should predictions prove inaccurate or scientific understanding advance. The concept would ensure that institutions, laws, and policies for the management


250. ADAPTIVE GOVERNANCE AND WATER CONFLICT: NEW INSTITUTIONS FOR COLLABORATIVE PLANNING 2-5, 6 (John T. Scholz & Bruce Stiftel eds., 2005).


of Lake Victoria are flexible to address the dynamic health, environmental, and economic challenges facing the Lake as the science, learning, and other evidence evolves. This provides a concrete basis for the following pivotal reforms to embed health more firmly into the sustainable management regime for Lake Victoria.

The East African Community, its Member States, and other stakeholders should also adopt and implement a long-term regional health and sustainability plan for Lake Victoria. This would avoid fragmented management and ensure coherent interventions that execute the three pillars of sustainability to promote public health and ecological integrity in the Basin. The EAC's strategic vision for Lake Victoria and the adoption of the Protocol on Sustainable Development of Lake Victoria is a start, but it requires effective development, implementation, and enforcement of and compliance with the instruments to achieve sustainability. A possible option would be to adopt a separate protocol on health and sustainable management of Lake Victoria. Such a protocol's sole objective would be the protection of human health and ecosystems, thereby tackling the public health challenges facing the Basin. This protocol would address issues such as safe drinking, bathing, and other uses of water, as well as sanitation, waste, and other measures to protect public health around the lake. This protocol would also contribute to the existing East African sustainable development regime by fully integrating the social pillar with the environmental and economic pillars in the management of Lake Victoria.

The stakeholders must adopt and implement a riparian-wide law and harmonize policy. Regional law for the sustainability of the Lake Victoria Basin must cross-fertilize domestic laws and policies of all riparian and catchment States—i.e., Kenya, Tanzania, Uganda, Burundi, and Rwanda. The EAC needs to put in place inter-sectoral coordination mechanisms for legal reform in this area. Domestic law and strategic policies, especially sector-wide frameworks, will need to be fully considered in the progressive harmonization and implementation of regional sustainability frameworks. These frameworks should not simply emphasize economic development and environmental management, but also the promotion of public health in the region. Existing legal reform initiatives such as the UNEP/UNDP Joint Project on Environmental Law and Institutions in Africa should be persuaded to include health within their remit by assisting the EAC in efforts to promote legal reform among Member States that integrate public health and the environment. This, in turn, requires effective governmental regulation to promote the Basin's catchment, which requires control of pollution from cities such as Kisumu, Kampala, and Mwanza. Furthermore, agriculture, forestry, and fisheries in riparian States should be targeted towards contributing to human health and ecosystems in the Basin. These reforms require the EAC to spearhead a comprehensive research and development agenda to promote the economic, social, and environmental pillars of sustainability evenly. This will provide a launch pad for enhanced health protection in the Basin.

Finally, the EAC, Member States, and other stakeholders should foster effective bottom-up civil society and local community participation. The importance of communities in promoting sustainability in the Lake Victoria Basin is demonstrated by the control of water hyacinth and use of traditional fishing methods on the Lake. Community participa-

tion in basic public health programs needs to be increased. By empowering communities, the EAC, Member States, and other stakeholders may help enforce existing and future public health laws, thereby promoting their own health. Convening, encouraging, and supporting community groups and regular consultations directly with institutions of the East African Community will promote this approach. But the voice of local communities around the lake must also be visible within the East African law and policy-making frameworks. This includes the promotion of participation of lake communities in the regional and domestic policy-making processes to promote sustainable management of the lake. The role of the civil society needs to be enhanced, and capacity building and funding should ensure that the three pillars of sustainability—economic, environmental, and social—are evenly addressed in these often donor-driven projects.

VII. Conclusion

This paper has demonstrated that public health protection is not optimized in the international legal regime for sustainable development of freshwater waters. The requirements of global and regional legal regimes applicable to freshwaters are biased towards the allocation of water quantity and access. Water quality and public health issues have not been comprehensively addressed. The anthropocentric and eco-centric divide in environmental protection; the progressive development of the environmental, economic, and social pillars of sustainability; and developments in human rights law highlight the constraints of the freshwater legal regimes for public health protection. The case study of the public health crisis facing the Lake Victoria Basin and the weaknesses of its regional sustainability legal regime for public health protection reinforce this view. These weaknesses are further highlighted by a focus on the economic needs of the basin over social and environmental needs and weak governance of environmental health. This is compounded by corruption and the lack of accountability of regulators, incoherent and weak sustainability, legal and soft policy instruments, regional and domestic sectoral fragmentation, and poor enforcement and compliance mechanisms. This paper adopts an adaptive and collaborative framework to suggest legal and practical options with the objective of re-invigorating public health protection in the sustainable governance of Lake Victoria, both at the East African regional and domestic planes.
Progressive IP Reform in the Middle Kingdom: An Overview of the Past, Present, and Future of Chinese Intellectual Property Law

JENNIFER WAI-SHING MAGUIRE*

Abstract

In the past several decades, China has established itself as a global leader in science and technology. However, the nation’s patent system is one of the youngest in the world, having only just implemented a third amendment to its patent law in 2008. International trade concerns pressure continuous reform of Chinese patent law and call into question the need for a fourth amendment. This article will discuss the past, present, and future of Chinese patent law. Part I will examine China’s political and cultural history, which has long discouraged the idea of individual ownership. Part II will provide an overview of China’s current intellectual property regime as well as a brief comparison of US and Chinese patent law after the America Invents Act. Part III will consider whether the Chinese government should implement a fourth amendment in order to ensure an effective Chinese patent regime.

Introduction

As one of the most rapidly developing countries in the past few decades, China has effectively burst onto the international intellectual property scene in recent years. The response to this burgeoning Asian power has been one of apprehension and unease, at

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1. See Jeff Sommer, Looking Beyond Europe, N.Y. TIMES, Dec. 11, 2011, at BU6 (explaining that China is expected to surpass the United States as the World’s Largest Economy by the year 2027 because it enjoys “largely sound government debt and deficit positions, robust trading networks and huge numbers of people all moving steadily up the economic ladder”); Rachel T. Wu, Comment, Awaking the Sleeping Dragon: The Evolving Chinese Patent Law and its Implications for Pharmaceutical Patents, 34 FORDHAM INT’L L.J. 549, 549 (2011); China to Surpass the US Economy in 5 Years, RT (Apr. 26, 2011, 12:59 AM), http://rt.com/usa/news/imf-china-surpass-usa-five-years/ (stating that “[t]he IMF has announced China will surpass the United States economically in real terms in 2016—a mere five years from” the article publication date).
least in the global intellectual property market. International trade concerns and China’s own interest in developing a strong intellectual property market have pressured continuous reform of China’s intellectual property laws in an attempt to meet the World Trade Organization’s (WTO) strict requirements. But many nations argue that China’s amendments fall short of WTO requirements and that China does not effectively enforce these new regulations. Various member nations of the WTO believe China’s undeveloped system of Intellectual Property Rights (IPR) unfairly infringes upon global market opportunities. In particular, the United States fears that IPR violations in China will undercut the profitability of American technology sales abroad.

As nations continue to identify market loss and tangible economic harm due to IPR infringement, global pressure on China to enforce its regulatory promises will only increase. The United States Trade Representative (USTR) has identified China as having one of the least developed and least effective IP regimes in the world. Piracy in China is estimated to have cost IP owners $2.4 billion worldwide in 2006. Furthermore, China’s copyright infringement caused an estimated $1.5 billion global loss. China’s patent docket is itself an example of the need for further IPR enforcement. Over four thousand patent infringement cases were filed in China in 2008. In fact, at the time, penalties for counterfeiting were so minimal they were viewed as business costs, creating only a neglig-

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4. See Wu, supra note 1, at 549-50; see also Donald P. Harris, The Honeymoon is Over: The U.S.-China WTO Intellectual Property Complaint, 32 FORDHAM INT’L L.J. 96, 97 (2008) (describing that although China adopted strong substantive IP laws, China has failed to enforce these laws); Newberry, supra note 3, at 1425 (explaining that despite achieving staggering success in copyright reform, it still has a “long way to go” in enforcing those standards).

5. See CHINA INTELLECTUAL PROPERTY INFRINGEMENT, supra note 2, at 27.

6. Id.

7. See Wu, supra note 1, at 549.

8. OFFICE OF THE U.S. TRADE REP., 2009 SPECIAL 301 REPORT 13 (2009), available at http://www.ustr.gov/sites/default/files/Full%20Version%20of%20the%202009%20SPECIAL%20301%20REPORT.pdf (declaring that China’s intellectual property rights enforcement regime remains ineffective); Kimberly N. Van Voorhis & Christie Yang, Recent Developments in Patent Law Worldwide, 997 PLI/PAT 405, 408 (2010) (stating that the “USTR’s Priority Watch List” includes China as having one of the least developed regimes).


11. Van Voorhis & Yang, supra note 8, at 408.
International patent holders face the additional risk of patent invalidation by petition of local Chinese pharmaceutical companies, as was the case with Pfizer’s Viagra patent. Thus, the ineffective enforcement of international IPRs in China has frustrated international litigants. Despite these fears, China’s IP system is undeniably in its infancy and is therefore capable of developing an effective patent system in the near future. With the most recent third amendment to China’s patent law, the country has taken a substantial step toward meeting the WTO requirements and appeasing other developed nations. As a response to continued complaints of an ineffective intellectual property regime, China amended its patent law for a third time in 2008. With increased monetary damages for infringers and additional administrative and judicial tools to better enforce patents, the Third Amendment is predicted to address many international concerns regarding China’s IP system. Whether this latest modification will suffice has yet to be seen.

Part I of this article discusses China’s recent history and the political atmosphere leading up to the Third Amendment. Part II discusses the sufficiency of China’s Third Amendment. Finally, Part III discusses the future of intellectual property rights in China and the need for further reform.

I. Past: 2000 Years of Political and Cultural Adversity to Intellectual Property Rights

Historically, China was not particularly receptive to the idea that intellectual property was a form of individual property that should be legally protected. But the government recognized that an established intellectual property regime was necessary to legitimize itself as a global leader. As this article examines the commencement of a Chinese intellectual property system and its subsequent amendments, it is important to understand the complex history of politics and culture that laid the groundwork for these changes. The Confucian, Taoist, and Communist historical background of China created an environ-

14. Harris, supra note 4, at 114-15 (stating that the United States filed a WTO complaint against China for IPR Infringement).
16. Id.
19. Id. at 12
ment unfriendly to the development of intellectual property rights. Chinese political culture further frustrated the development of IPRs when Communism gained control of the country.\textsuperscript{21} In recent decades, China has made significant improvements to its IP system.\textsuperscript{22} However, the WTO and its member nations agree that the country still has a long way to go in enforcing its new IP laws.\textsuperscript{23}

A. \textsc{Intellectual Property Rights versus “The Way” of Taoism and Confucianism}

China’s under-developed IP regime is, in part, the result of a Confucian and Taoist emphasis on sharing property and discouragement of individualism (\textit{The Way}).\textsuperscript{24} For two thousand years, China encouraged its citizens to share inventions, discoveries, and creative works.\textsuperscript{25} The sole reward for successful intellectual achievements was public recognition and endowments from the King or Emperor.\textsuperscript{26} As Alexander Chen stated, \textquotedblleft[[l]earning was not an individual pursuit, it was a community goal.	extquotedblright\textsuperscript{27} Taoism promoted harmony, balance, and social totality.\textsuperscript{28} Confucianism eschewed the idea of personal gain at the expense of others.\textsuperscript{29} Together, both Confucianism and Taoism embodied a way of life for most Chinese people.\textsuperscript{30}

This way of life was reflected in almost every aspect of Chinese society. Traditionally, copying was a legitimate method of learning in China.\textsuperscript{31} Students of sculpture, painting, and calligraphy honored their master by copying his style and work closely.\textsuperscript{32} The more people who admired a master’s work, the more it was copied and spread, increasing the master’s success and popularity.\textsuperscript{33} The national acceptance of copying combined with a tradition of isolationism and distrust of outsiders\textsuperscript{34} further discouraged any development of internationally recognized IPRs.\textsuperscript{35}
Despite having a religious and cultural background that discouraged IPRs, China began to recognize such rights around the turn of the 20th century. In 1898, China implemented its first patent act, the Reward Regulations for Promoting Technology Development (Zhengxing Gongyi Gejiang Zhangcheng). In 1903, China signed its first bilateral patent treaty with the United States, constituting “the most important convention made by the United States with any oriental country.” The Treaty accomplished two major goals: (1) “the extension of the United States international copyright laws to China,” and (2) “the promise from China to establish a patent office in which the inventions of citizens of the United States may be protected.” In 1910, the Chinese emperor enacted the first written national statute on copyrights. In this manner, IPRs slowly gained momentum in China.

B. The Cultural Revolution and the Communist Regime

Despite a trend of strengthening IPRs and international IP treaties in China, progress in China’s intellectual property regime came to a halt with the onset of communism. Between 1945 and 1949, the Communist Party combated the Nationalist Party for control of the political system. Even decades before 1949, communists controlled areas around the country, influencing politics and culture to create “Soviet-like” microcosms. Therefore, when the Communist Party gained control in 1949, a strong sense of the communist ideology had already spread throughout the nation. Communist policies promoted sharing property and discouraged individual ownership. Commentators have noted that the communist principles of shared property flowed seamlessly from China’s Confucian and Taoist background, providing an easy transition.

China adopted a two-track approach toward patents, imitating the approach taken by the Soviet Union. The “first track” discouraged individual property ownership in an invention by awarding only a “certificate of invention.” The certificate was essentially meaningless to the holder because it attributed ownership and rights to the government.
including the right to disseminate and collect royalties from the invention. The “second track” of Chinese patent law at this time issued a true patent to the inventor, including the right to receive royalties. Qualifying for this type of patent was not only difficult, but the government had the right to confiscate the invention at any time if the product concerned “national security,” or “affected the welfare of the great majority of people.” As a result, by 1963 property rights in patents were essentially abolished.

In the decades following the establishment of a communist regime in China, further cultural movements halted the IP system almost entirely. During the period from 1966-1976, Chairman Mao instigated the Cultural Revolution to prevent the formation of the bureaucratic communism that had developed in the Soviet Union. The movement led to the imprisonment of writers, scientists, doctors, and many other intellectuals in an attempt to eradicate individualism. For the next decade, China lacked an IP system entirely due to the renunciation of all previously established patent laws. In 1969, Chairman Mao declared an official end to the Cultural Revolution, but the movement continued to be active until the death of military leader Lin Biao in 1971.

C. DENG XIAOPING AND THE REBIRTH OF CHINA’S IP SYSTEM

A period of aggressive cultural and political reform began when Deng Xiaoping came into power. He recognized that foreign investment was essential to China’s future and that the implementation of an IP regime was necessary to attract international business. Consequently, in 1979, China began drafting patent laws to improve IPRs, and in 1980, China joined the World Intellectual Property Organization (WIPO). In 1984, China enacted its first patent law in decades, listing the methods for patent application, the patent examination process, and the protection strength of effective patents. But the 1984 patent law lacked essential features. For example, the law excluded patents for inventions

50. Id.
51. Id.
52. Peter Ganea & Thomas Pattloch, Intellectual Property Law in China 3 (Christopher Heath ed., 2005); Wu, supra note 1, at 533-54.
54. Id.; Wu, supra note 1, at 533.
55. Id.
56. Id.
58. Ganeel, supra note 24, at 328 (stating that “[w]hen Deng Xiaoping resumed power . . . the Chinese government began an ambitious program of economic and legal reform”).
59. Id. at 328-29 (explaining that Deng Xiaoping believed a national patent system would attract overseas investment).
61. See McCabe, supra note 38, at 17.
that involved food, pharmaceuticals, and beverages.\textsuperscript{63} Although the law was later amended in 1992 to cover pharmaceutical patents, it still offered little protection.\textsuperscript{64} The second and third amendments were adopted in 2001 and 2008 in an attempt to expand the intellectual property regime.\textsuperscript{65}

In the most recent decades, China has made continuous efforts to expand its intellectual property system.\textsuperscript{66} But local governments have hindered these efforts because of their increasing autonomy and power.\textsuperscript{67} In an effort to gain recognition in the global arena and strengthen its intellectual property regime, China joined the WTO in 2001.\textsuperscript{68} Upon China’s acceptance into the WTO, member states demanded that China assume more obligations than other member states due to its under-developed IP system.\textsuperscript{69} Member states further argued over China’s status as a developing country.\textsuperscript{70} Developing countries were afforded more benefits and flexibility than developed countries in the WTO.\textsuperscript{71} China was ultimately classified as a developed country for the purposes of IP laws, as it was the third largest trading nation and received more foreign investment than any other country.\textsuperscript{72} Thus, China was forced to agree to implement patent provisions that met the requirements of Trade-Related Aspects of Intellectual Property Rights (TRIPS).\textsuperscript{73} Instead of the five-year grace period that was afforded to developing countries, the WTO required China to immediately implement IP laws that would meet the minimum requirements of TRIPS.\textsuperscript{74} The nation has largely complied with the provisions of TRIPS by enacting laws that meet the minimum requirements,\textsuperscript{75} but other nations within the WTO have criticized China for ineffectively enforcing these new laws.\textsuperscript{76}

II. Present: China’s Current IP Regime

With its most recent IP laws and amendments, China has come a long way from the political and cultural history that strongly discouraged individual ownership. But its patent law system today contains two of the same flaws that caused China’s two previous attempts to fail: (1) the fact that IP laws were not voluntarily implemented in China, but rather were encouraged or required by Western countries; and (2) the significant amount

\begin{footnotesize}
\begin{enumerate}
\item[63.] Id. art. 25(4)-(5).
\item[64.] Wu, supra note 1, at 553.
\item[65.] Id. at 553.
\item[66.] Id. at 555.
\item[68.] See Gabriel, supra note 24, at 1008.
\item[69.] See Wu, supra note 1, at 556.
\item[70.] Harris, supra note 4, at 110-11.
\item[71.] Id. at 109-11.
\item[72.] Id. at 111; Wu, supra note 1, at 556.
\item[74.] See Protocol on the Accession of the People’s Republic of China, pt. I, ¶ (2)(A), Nov. 23, 2001, WT/L/ 432; Harris, supra note 4, at 112.
\item[76.] Smith, supra note 73, at 645.
\end{enumerate}
\end{footnotesize}
of control China retains over issued patents, resulting in a decreased sense of ownership and a reduced incentive to invent.77 These two qualities were exhibited in both the Treaty of 1903 and Regulations of the 1950s.78 This pattern might signal that, despite China’s best intentions, Chinese IP law has not laid a foundation capable of change.79

A. THE THREE AMENDMENTS TO CHINESE PATENT LAW SINCE 1984

Since its first patent law was enacted in 1984, China has amended its patent law three times over the past two decades.80 In 1992, Chinese patent law was amended to expand patentable subject matter to include pharmaceuticals as well as to extend the patent length from fifteen to twenty years.81 In 2000, China amended its patent law for the second time, in anticipation of accession to the WTO.82 The second amendment strengthened patent protection and enforcement and attempted to assist foreign countries and individuals to file patents in China.83 The second amendment was ultimately unclear in its terms, resulting in a large amount of bad faith applicants who filed for patents of prior arts and immediately accused others of infringing on their patents.84 Due to these deficiencies, China again amended its patent law for a third time in 2008.85

China’s Third Amendment signaled new hope for a sufficient national patent regime. On June 5, 2008, China’s State Council issued the National Intellectual Property Strategy Outline, which set a goal of improved creation, utilization, protection, and administration by 2020.86 This led to the finalization of the Third Amendment in December of 2008, which increased monetary damages against infringers and provided additional administrative and judicial tools to better enforce IPRs.87

The Third Amendment also clarified that two types of patent law violations are illegal: (1) acts of “passing off” patents and (2) patent infringement.88 “Passing off” occurs when
an individual deceptively portrays that an unpatented invention is patented.\(^{89}\) This includes manufacturing a product with a patent marking, continuing to manufacture a product with an invalidated patent, advertising unpatented technology as patented technology, and forging any patent certificate, document, or application.\(^{90}\) The Third Amendment increased the civil fines for “passing off.”\(^{91}\) In addition to confiscating the profit earned on a product that has been “passed off,” the Patent Administrative Department may impose a fine four times the illegal income and three times the illegal earnings.\(^{92}\) Furthermore, the Third Amendment provided more resources to investigate “passing off” patents in an attempt to reduce their overall occurrence.\(^{93}\)

The Third Amendment further mandated that compensation for patent infringement be based on the actual losses of the patentee or the profit made by the infringer.\(^{94}\) To clearly define infringement, the amendment added three paragraphs to article 2 which clarified the meaning of “design,” “invention,” and “utility.”\(^{95}\)

Despite these harsher penalties, the Third Amendment also made it harder for patentees to obtain patents and easier for infringers to assert defenses.\(^{96}\) Article 22 was amended to adopt the “absolute novelty” national standard.\(^{97}\) This heightened novelty standard increased the requirements for obtaining a patent. On the other hand, the Third Amendment also expanded non-infringement defenses by codifying the prior art defense, thereby permitting a defendant to argue that the invention or design was revealed by prior art.\(^{98}\)

These changes to China’s patent system have stirred national optimism and encouraged market growth in the patent area. But many argue that despite an improved legal system, China has failed to ensure that these regulations are enforced at the local level.\(^{99}\)


\(^{91}\) 2008 Patent Law, supra note 89, art. 3.

\(^{92}\) Wu, supra note 1, at 576.

\(^{93}\) Id. at 577.

\(^{94}\) 2008 Patent Law, supra note 89, art. 65.

\(^{95}\) Id. art. 2.

\(^{96}\) See Wu, supra note 1, at 578-80.

\(^{97}\) 2008 Patent Law, supra note 89, art. 22 (“Novelty means that the invention or utility model concerned is not an existing technology; no patent application is filed by any unit or individual for any identical invention or utility model with the patent administration department under the State Council before the date of application for patent right, and no identical invention or utility model is recorded in the patent application documents or the patent documentations which are published or announced after the date of application.”).

\(^{98}\) Id. art. 62.

B. The Essential Problem with the Current IP System: Enforcement

Although China’s recently introduced patent reform initially sparked high hopes, time has shown that the country has fallen far behind in enforcement mechanisms.\textsuperscript{100} China relies on administrative or adjudicative mechanisms to enforce IP laws in both the criminal and civil context.\textsuperscript{101} But these mechanisms are often ineffective against infringement.\textsuperscript{102}

Administrative relief is often used to handle pharmaceutical patent infringement cases.\textsuperscript{103} China’s State Intellectual Property Office (SIPO) handles the granting and enforcement of patents.\textsuperscript{104} SIPO’s enforcement mechanisms include investigation, mediation, imposition of fines, “[a]nd providing cease-and-desist orders through provisional offices and agencies.”\textsuperscript{105} Patent holders may file a request for an administrative investigation into infringement at a local SIPO office.\textsuperscript{106} If the local SIPO office agrees with the filer and finds for infringement, the patent administrative authority may order the infringer to immediately terminate his or her actions.\textsuperscript{107} The infringer has fifteen days to file an appeal in court.\textsuperscript{108} Starting when the patentee becomes aware of an infringement, a patent holder has two years to file a patent infringement suit before the statute of limitations bars such action.\textsuperscript{109} If the patentee files suit within this two-year period and the infringement is deemed to be criminal, a criminal investigation of the infringer will also ensue.\textsuperscript{110}

Although SIPO has broad power to enforce equitable remedies, the office more often issues monetary penalties that are insufficient to discourage infringers from repeat violations.\textsuperscript{111} SIPO has the power to enjoin the infringer from continuing to manufacture, to order the destruction of infringing products, and to confiscate machinery used to make infringing products.\textsuperscript{112} However, infringers often receive only a monetary penalty, which is not distributed to patentees, but kept by the government.\textsuperscript{113}

\textsuperscript{100} Wu, supra note 1, at 557.
\textsuperscript{102} Id. at 452, 455-56.
\textsuperscript{103} Id. at 452, 454.
\textsuperscript{104} Id. at 453.
\textsuperscript{105} Wu, supra note 1, at 557.
\textsuperscript{108} Id. (explaining that if the party concerned is not satisfied with the decision, he or it may, within fifteen days from the receipt of the notification of the order, institute legal proceedings in the people’s court according to the Administrative Procedure Law of the People’s Republic of China).
\textsuperscript{109} Id. art. 62.
\textsuperscript{110} Id. art. 58 (explaining that where the infringement constitutes a crime, the party shall be prosecuted for his criminal liability).
\textsuperscript{111} See Bronshtein, supra note 101, at 455-56.
\textsuperscript{112} Id. at 453-54.
\textsuperscript{113} Id.
The SIPO office itself lacks the financial means, and therefore the motivation, to improve enforcement methods and train staff.\(^\text{114}\) Because the counterfeiting business may be a significant portion of the local economy, local governments may be hesitant to provide more financing to SIPO offices despite the fact the SIPO offices receive no outside funding.\(^\text{115}\) Consequently, staff is insufficiently trained to enforce cease-and-desist orders, and little incentive is provided by the local community to do so.\(^\text{116}\) Infringement cases are often not sent to criminal authorities because doing so would disrupt the local economy.\(^\text{117}\)

Because of these difficulties and because of the overwhelming complexity of patent infringement cases, adjudicative relief is more often sought by patentees.\(^\text{118}\) China’s judicial system consists of four levels.\(^\text{119}\) First, the Basic People’s Court handles the first instance of cases at a local level.\(^\text{120}\) Second, the Intermediate People’s Court handles relevant important local cases in the first instance and hears appeals from the Basic People’s Court.\(^\text{121}\) Third, the Higher People’s Court is the highest local court in China, and its jurisdiction corresponds with the province or large city in which it is located.\(^\text{122}\) The Supreme People’s Court is the highest court in the mainland area of China (excluding Hong Kong and Macau).\(^\text{123}\)

In these courts, the method used for determining whether infringement has occurred is simple.\(^\text{124}\) Chinese courts have not yet developed effective methods for determining infringement and cannot use case law to guide future cases.\(^\text{125}\) Additionally, plaintiffs must gather and present “their own evidence to meet” the burden of proof.\(^\text{126}\) Chinese courts only permit evidence “in its original form”\(^\text{127}\) and only sometimes allow evidence from certain previous court proceedings.\(^\text{128}\) If evidence originates from outside of China, it “must be notarized in the originating country” and “authenticated by the Chinese embassy

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114. See id. at 454.
115. Evans, supra note 99, at 591 (explaining that local governments are often reluctant to provide funding for administrative agencies’ operations because they benefit financially from the piracy).
116. Id.
117. See id.
118. Intellectual Property Rights, supra note 106 (stating in relevant part that “[p]atent disputes remain the most likely of intellectual property right disputes to be adjudicated, due in large part of their relative complexity”).
120. Id.
121. Id. at 457-58.
122. Id. at 457.
123. Id.
125. Id.; see also Laurie Self & Jason Ma, Amending China’s Trademark Law: A Discussion of the Possible Changes to Trademark Law in China, 218 TRADEMARK WORLD 18, 20 (2009) (noting that there is no stare decision in China and that case law is not binding on lower courts).
127. Wu, supra note 1, at 560.
or consulate. For these reasons, the analysis portion of a trial may last for several days.

Furthermore, monetary penalties that courts actually impose for patent infringement are an insufficient deterrent. Before the third amendment to Chinese patent law, the maximum for civil penalties was set at 500,000 Yuan, or about $62,500. But the number of patent infringement cases has continuously risen in China, and the maximum fine today is three times the infringer’s income, which includes calculations of the infringer’s profit and the patentee’s losses. Despite this heightened ceiling, actual fines imposed average less than $800. Thus, what seems to be an effective penalty regulation is, in reality, not much of a deterrent.

In the criminal context, China’s IP system is also lacking. Chinese law suggests criminal prosecution only if “the circumstances are serious.” Such ambiguous statutory language allows for broad interpretation and generally results in overlooking infringement. In fact, local governments often pressure judges to utilize this broad discretion to ignore patent infringement cases before them. When a criminal prosecution is actually successful, the system allows for a three-year maximum sentence if “the circumstances are serious” and a seven-year maximum sentence if “the infringement is of ‘a more serious nature.’” Once again, this broad statutory language leaves significant ambiguity and

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129. Wu, supra note 1, at 560.
130. Bai, Wang & Chen, supra note 124, at 6 (stating that “[c]laim construction and infringement analysis occur at trial, which might last between half a day and a couple of days”).
132. Id.
133. Id. (stating that the number of IP infringement civil cases has increased from 5200 in 2001 to 7800 in 2002).
134. 2000 Patent Law, supra note 107, art. 58.
137. Id.; Wu, supra note 1, at 563.
permits courts to exercise minimum enforcement penalties. Furthermore, local legislatures may enact their own IP laws, resulting in inconsistent IPRs across China.

C. A Comparison of American and Chinese Patent Law

In addition to the U.S. concern that China’s enforcement mechanisms are lacking, major differences between American and Chinese patent law have furthered tension and distrust between the two countries. These differences previously included defenses to infringement, patent priority, prior use rights, grace periods, and best-mode requirements. But two of these differences disappeared with the Leah Smith America Invents Act (AIA), the most significant change to U.S. patent law in decades.


President Barack Obama signed the AIA into law on September 16, 2011, thus eliminating two major differences between Chinese and American patent law that previously existed: (1) patent priority and (2) prior use rights. Although the new language has yet to be interpreted by courts, the AIA might actually soothe some of the tension between China and the United States that erupted from differing patent systems.

Most significantly, the AIA switched the U.S. patent system from “first to invent” to “first to file.” Thus, America’s patent priority laws now comport with China as well as most other countries around the world, moving it toward the international standard. This change will also greatly reduce patent litigation in the United States through the implementation of post-grant review proceedings.

141. Wu, supra note 1, at 563.
143. See Wu, supra note 1, at 561-62.
146. Id.; compare Wu, supra note 1, at 563, with Corbett, supra note 144, at 718-19.
148. See Schacht & Thomas, supra note 144, at 8.
Secondly, the AIA also brought prior use rights into the American patent arena, a defense inherent in a first-to-file system.\textsuperscript{150} Previously, the American Patent Act employed a narrow prior use defense limited to infringement claims of business methods.\textsuperscript{151} The new statute greatly expands the prior use defense to include any good-faith commercial uses, arm’s length sales, and commercial transfers that occurred at least one year before the earlier of either (1) the effective filing date of the patent application or (2) the inventor’s public disclosure that is an exception to prior art under the AIA’s limited grace period.\textsuperscript{152}

Despite these recent legislative changes that bring China and the United States closer into alignment, many significant differences in IP still exist between the two countries.\textsuperscript{153} The following sections will explore three of the most significant differences: infringement defenses, grace periods, and the best-mode requirement.

2. **Defenses to Infringement in China and the United States**

First, China provides defenses to infringement that are not available in the United States.\textsuperscript{154} The United States provides few specific defenses to infringement.\textsuperscript{155} Judicially created defenses include experimental use,\textsuperscript{156} inequitable conduct,\textsuperscript{157} and patent misuse.\textsuperscript{158} U.S. courts have generally justified these defenses on public policy grounds.\textsuperscript{159} In addition, 35 U.S.C. §§ 273 and 282 provide statutory defenses to infringement.\textsuperscript{160} Section 282 lists the most commonly used defenses to infringement that permit argument as to the validity of the patent,\textsuperscript{161} This type of argument depends on establishing bars to patentability, such as a finding of prior public use,\textsuperscript{162} obviousness of the invention,\textsuperscript{163} prior art,\textsuperscript{164} and patent misuse.

\begin{footnotesize}
\begin{itemize}
  \item[151.] American Invents Act: Prior Use Defense, supra note 150.
  \item[153.] See supra section II(C) (stating that the major differences between the United States and China are definitions of infringement, grace periods, and prior user rights); see also Chow, supra note 135.
  \item[154.] McCabe, supra note 38, at 21.
  \item[155.] Id.
  \item[156.] ROBERT P. MERGES ET AL., INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE 321-25 (rev. 4th ed. 2007) (explaining that experimental use allows the inventor to use the product for the purpose of perfecting it or verifying its operability).
  \item[157.] Id. at 325-31 (explaining that even where the court determines that infringement has occurred, the court may still choose not to enforce the patent if the patentee has engaged in inequitable conduct).
  \item[158.] Id. 331-37 (explaining that patent misuse is an affirmative defense that broadly describes any misuse of a patent).
  \item[159.] McCabe, supra note 38, at 21.
  \item[161.] See id. § 282(2) (invalidity based on prior art); § 282(3) (invalidity based on failure to describe the invention clearly and with sufficient).
  \item[162.] Evans Cooling Sys., Inc. v. Gen. Motors Corp., 125 F.3d 1448, 1452 (Fed. Cir. 1997) (stating that prior public sale invalidated the patent).
  \item[163.] KSR Int’l Co. v. Teleflex Inc., 550 U.S. 398, 422 (2007) (combining prior art references to hold that respondent’s patent was invalid for obviousness).
  \item[164.] Advanced Display Sys., Inc. v. Kent State Univ., 212 F.3d 1272, 1282 (Fed. Cir. 2000) (“[I]nvalidity by anticipation requires that the four corners of a single, prior art document describe every element of the claimed invention, either expressly or inherently, such that a person of ordinary skill in the art could practice the invention without undue experimentation.”).
\end{itemize}
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and non-patentable subject matter. Section 273 previously only allowed a defendant to argue prior use of a business method, an exceedingly narrow defense. But the AIA has expanded prior use rights under § 273 to apply broadly to infringement for commercial purposes.

In comparison to U.S. law, Chinese patent law expands upon these defenses significantly. These defenses are often nebulously worded and provide vague limitations. Most notably, a general provision of Chinese patent statutes proscribes patents that are “contrary to the laws of the state or social morality or that [are] detrimental to public interest.” This vague statutory defense permits courts to invalidate a patent ad hoc if sharing the invention is determined “to promote the progress and innovation of science and technology, and meet[s] the needs of the socialist modernization drive.” Furthering this ambiguity is a catchall provision that gives the government the right to permit exploitation of the invention “where public interest so requires.”

Chinese statutes also expand on U.S. infringement defenses by implementing two “innocent infringer” defenses. The first provides a defense to an infringer who, before the filing date, “has already manufactured identical products, used identical method[s], or has made necessary preparations for the manufacture or use and continues to manufacture the products or use the method within the original scope.” Although there is a somewhat analogous principle under U.S. trademark law, there is no such defense in U.S. patent law unless the patent itself is invalid due to prior use.

Second, under Chinese patent law an infringer may be innocent if he or she does not know “that [the invention was] produced and sold without permission of the patentee.” The statute explicitly rules out damage awards, stating that the infringer “shall not be liable for compensation provided that the legitimate source of the product can be

169. Id. at 22.
170. 1984 Patent Law, supra note 62, art. 5; cf. id. art. 45, (“[I]f a unit or individual believes that such grant does not conform to the relevant provisions of this Law, it or he may request that the patent review board declare the said patent right invalid.”).
171. Id. art. 1; see generally KARLA C. SHIPPEY, A SHORT COURSE IN INTERNATIONAL INTELLECTUAL PROPERTY RIGHTS: PROTECTING YOUR BRANDS, MARKS, COPYRIGHTS, PATENTS, DESIGNS, AND RELATED RIGHTS WORLDWIDE (3d ed. 2009).
172. 1984 Patent Law, supra note 170, art. 49.
173. McCabe, supra note 38, at 23.
174. 1984 Patent Law, supra note 170, art. 69(2).
175. See Weiner King, Inc. v. Wiener King Corp., 615 F.2d 512, 523 (C.C.P.A. 1980) (holding that a business may use its trademark in any geographic area except that of another entity holding a prior similar mark).
176. See Woodland Trust v. Flowertree Nursery, Inc., 148 F.3d 1368, 1370, 1373 (Fed. Cir. 1998) (holding that a claim of prior use ineffective and stating that “in order to invalidate a patent based on prior knowledge or use, that knowledge or use must have been available to the public”).
177. 1984 Patent Law, supra note 170, art. 63.
proved."\textsuperscript{178} The language does leave open the possibility for injunctive remedies.\textsuperscript{179} But once again, the statutory language is not entirely clear as to the scope of the defense. Interpreted broadly, infringers may claim ignorance in order to validate their actions.\textsuperscript{180} This type of attitude creates a risk of fraud, discouraging an infringer from investigating its suppliers and encouraging willful blindness.\textsuperscript{181} Therefore, although China does not employ stare decisis, and thus lacks any judicial defenses to infringement, China’s statutory defenses greatly outnumber the defenses available in the United States and provide for a comparatively weaker IP system.

3. \textit{The Grace Period}

China and the United States also differ in terms of the “grace period,” a statutory exception in the United States that gives an inventor one year to freely publicize his or her invention in the market without waiving any patent rights.\textsuperscript{182} This is an exemption from the general rule that a patent shall not be issued for an invention that is already publicly available.\textsuperscript{183} For example, a patent will not be issued in the United States for an invention that was described in a printed publication anywhere in the world more than one year before the application was filed in the country.\textsuperscript{184} Additionally, a patent will not be issued in the United States for an invention that was in public use or on sale in the country more than one year before the file date.\textsuperscript{185} The purpose of this one-year grace period is to allow the inventor to attract investors, to tweak the invention, and to develop market strategies.\textsuperscript{186} The grace period starts when the inventor or a third party runs a printed publication of the invention, initiates public sale, or initiates public use.\textsuperscript{187}

The implementation of the America Invents Act has altered grace periods only slightly, although the real effect of the Act remains to be seen.\textsuperscript{188} After much Congressional debate, the AIA grace period does not change the one-year time period.\textsuperscript{189} But the final version of the AIA redefines what disclosures inventors can make.\textsuperscript{190} Commentators note that this section of the AIA is highly ambiguous, and inventors will have to wait and see how courts will interpret the language.\textsuperscript{191}

Regardless of the future implications of the AIA, China differs starkly from the United States because it lacks a grace period entirely for public use, public availability, or printed

\begin{footnotesize}
\begin{enumerate}
\item Id.
\item Id.
\item See McCabe, supra note 38, at 24.
\item Id.
\item Wolfe, supra note 182.
\item Corbett, supra note 144, at 719.
\item Id.
\item Id.; SCHACHT & THOMAS, supra note 144, at 16.
\item Wolfe, supra note 182.
\item Wolfe, supra note 182.
\item Id.
\end{enumerate}
\end{footnotesize}
publication. In China, a patent will not be issued at all for an invention that has been publicly used, publicly known, or disclosed in a publication in any country. As a result, Chinese inventors must file for patents before they publish any information about their inventions. But there are three limited exceptions that provide an inventor with a six-month grace period. Such a grace period is issued where an invention (1) was first exhibited at a Chinese Government sponsored or recognized international exhibition, (2) was first made public at an approved academic or technological meeting, or (3) was disclosed without the applicant’s consent (“innocent infringer”).

For example, GlaxoSmithKline was forced to drop its claim that Chinese companies were infringing on its patent of Avandia, a diabetes drug. The claim failed because the company had published information about the drug before filing for a patent. Therefore, the novel elements essential to Avandia were available to the public, and Chinese patent law considered them free to be appropriated for commercial use.

4. Best Mode Requirement

Finally, the AIA modification of U.S. patent law has widened the differential gap between the best mode requirement in China and the United States. The AIA eliminated the “best mode analysis” as a basis for invalidity. Before this change, infringers could assert “the defense that the patent [was] invalid because the patentee failed to disclose the best mode of practicing the invention.” Although the best mode defense is no longer available to invalidate patents, § 112 still requires a patentee to comply with the best mode requirement through disclosure. The new law simply states that a failure to do so does not result in invalidation. Language eliminating the best mode requirement was first introduced in the Patent Reform Act of 2007 by Representative Mike Pence.

Analysis
of this language provides the rationale for removing the best mode invalidity defense.\textsuperscript{206} Removal of this defense not only reduces the burden on courts, but also prevents an abusive, overly litigious system that encourages defendants to attempt to invalidate patents.\textsuperscript{207} The danger of such a system is that it detracts from the infringement itself and costs American inventors millions of dollars in legal fees.\textsuperscript{208}

In contrast, the Chinese patent law’s best mode requirements are much stricter, thereby making it easier for a defendant to invalidate a patent on this basis.\textsuperscript{209} “Under Chinese patent law, the applicant is required to disclose enough information to enable a person skilled in the relevant field of technology to understand and exploit the invention.”\textsuperscript{210} Specifically, the patentee must describe “in detail the optimally selected mode contemplated by the applicant for carrying out the invention or utility model.”\textsuperscript{211} As a noteworthy example, SIPO invalidated Pfizer’s Viagra patent because, instead of one ingredient, it listed nine compounds as “particularly preferred individual compounds.”\textsuperscript{212} It was therefore not sufficiently descriptive under Chinese patent law.\textsuperscript{213} Subsequently, the Patent Reexamination Board (PRB) did overturn SIPO’s decision and validate Pfizer’s Viagra patent.\textsuperscript{214} But the initial conflict represents an example of differences in best mode requirements. After the AIA’s abolition of best mode invalidation is implemented, U.S. patent law will be further polarized from Chinese patent law, which more easily permits patent invalidation based on failure to meet China’s strict best mode requirements.

III. Future: The Need for a Fourth Amendment?

In the face of China’s apparent progress, scholars still debate whether the latest amendment to its patent law is enough.\textsuperscript{215} Some contend that the Third Amendment falls short of addressing China’s full spectrum of patent problems, while some believe it adequately resolves the prominent legal gaps left by the second amendment.\textsuperscript{216}

\textsuperscript{207} Id. at 157-58.
\textsuperscript{208} Id. at 133, 141-42, 153.
\textsuperscript{209} Wu, supra note 1, at 567.
\textsuperscript{210} Id.
\textsuperscript{213} Id.
\textsuperscript{215} Bai, Wang & Chen, supra note 124, at 72-73; Wu, supra note 1, at 585.
\textsuperscript{216} Bronshtein, supra note 101, at 444-45, 447.
For example, Benjamin Bai, author of What Multinational Companies Need to Know about Patent Invalidation and Patent Litigation in China, optimistically comments that the Third Amendment will resolve many of the previous deficiencies in Chinese patent law. He attempts to deflate the belief that Chinese courts favor domestic plaintiffs and encourages foreign investors to familiarize themselves with China’s IP system to utilize its patent laws for protection. Other proponents claim that the new absolute novelty requirement will relieve the concerns that international companies have regarding Chinese patents of their ideas and, therefore, encourage foreign investment.

However, many call into question the adequacy of the Third Amendment because of doubts that the new regulations will be enforced on a local level. These scholars believe that local governments fall victim to the pressures of an economy that depends on counterfeiting or other types of infringement. Counterfeitors provide indirect financial benefits to their local economies by putting their profits back into the system—patronizing restaurants, shops, and generally acting as local consumers. Furthermore, local officials are not only known for accepting bribes to look the other way, but sometimes participate firsthand in the counterfeiting business. Without a centralized government that enforces its patent laws at a local level, local Chinese governments will continue to operate as they always have.

Proponents of a fourth amendment encourage the central government to take a stand in several ways. One solution would be to re-route funding previously given to local governments directly into administrative agencies to ensure it is being used for enforcement. Additionally, a uniform SIPO training program could be implemented to remove the disparities between different SIPO locales. Specific solutions such as these could help wean local economies off counterfeiting and encourage creative development at the regional level.

218. Id.
219. See Wu, supra note 1, at 584 (“Under the absolute novelty requirement, Chinese companies cannot file for a drug patent if the drug has been patented elsewhere in the world.”).
221. Bronshtein, supra note 103, at 459 (“[T]his central level authority is comprised mainly of legislative and policy-making bodies, while actual implementation and enforcement of law occurs at the local level.”); see Maria Nelson et al., Counterfeit Pharmaceuticals: A Worldwide Problem, 96 Trademark Rep. 1068, 1089 (2006) (“Enforcement efforts, particularly at the local level, are hampered by poor coordination among Chinese Government ministries and agencies, [and] local protectionism and corruption . . . .”).
222. Bronshtein, supra note 101, at 463.
223. Id. at 460.
224. Id. at 459-60, Evans, supra note 101, at 591 (stating that “many local officials directly profited from piracy through kickbacks and bribes, while other high-ranking officers were involved firsthand in the production of illegal goods and services”).
225. Evans, supra note 99, at 591.
226. Wu, supra note 1, at 590-91.
227. Id. at 591.
228. Id.
Thus, while the Third Amendment represents a significant step toward developing a rigorous IP regime, it will remain largely ineffective unless local government autonomy and corruption is dissolved.\footnote{229. See id. at 589 (asserting that “Chinese patent law will continue to be ineffective as long as local government corruption and protectionism exists”).}

IV. Conclusion

Considering China’s tumultuous political and cultural background in the past century, its IP regime has developed relatively rapidly. International trade concerns that China will continue to infringe global IPRs should be tempered with the understanding that China’s IP system is one of the youngest in the world. China has taken several solid steps toward rebuilding its IP laws. First, China has joined the WTO and several international intellectual property organizations to show its dedication to implementing IPRs. Second, China implemented its first patent law since the end of the Communist Regime in 1984. Finally, China has amended this law twice in response to international complaints that its laws were ineffective.

Despite these efforts, China’s patent laws are still not sufficient. Although the Third Amendment promises to make vast improvements to China’s patent law, the enforcement problem in China will persist as long as local government infrastructure is left untouched. To address the enforcement problem, China’s centralized government should assert regulations by directing funding away from unstable local governments and toward administrative agencies. The government should also ensure that SIPO is uniformly training officers and enforcing regulations throughout the country. Although these changes cannot happen overnight, an initial recognition of the root of the problem is necessary to ensuring a sustainable IP regime in China’s future.
Patent Box Taxation: A Comparison of Four Recent European Patent Box Tax Regimes and an Analytical Consideration of If and How the United States Should Implement Its Own Patent Box

JASON M. BROWN

Abstract

As the global economy is increasingly driven by the commercialization of highly mobile assets, several European governments have sought to encourage investment in and retention of such assets within their domestic borders by offering heavily incentivized tax rates on profits derived from patents and other highly mobile assets. Notable among the European and Asian countries to enact such patent-income tax incentives—colloquially known as patent box tax regimes—are Belgium, Luxembourg, the Netherlands, and the United Kingdom. This paper addresses the primary distinguishing features of these four regimes, including their effective tax rates, their scope, and their general qualification requirements and further addresses the preliminary economic results of the enactment of these regimes. Finally, this paper considers the shortcomings in the four regimes and discusses how the United States can capitalize on such shortcomings to enact a more effective patent box tax regime.

I. Introduction

A. Preface

The ongoing competition between the governments of major economic powers to entice foreign nationals to invest within domestic borders has increasingly forced such governments to develop creative and innovative methods for reducing effective tax rates for potential foreign corporate investors, especially on more mobile and more highly sought after assets. One of the most recent and most rapidly growing corporate tax incentives enacted by several national governments in an attempt to lure foreign innovation-based
investment is what has become colloquially known as the patent box tax regime. Stated simply, patent box taxation refers to the application of a “sharply reduced . . . rate of corporate tax applied to income resulting from qualifying [intellectual property].” Since 2007, several European and Asian governments, including Belgium, China, France, Luxembourg, the Netherlands, and Spain, have added some form of patent box taxation to their corporate tax systems. Additionally, the United Kingdom is currently in the process of enacting their own patent box legislation, which is presently set to go into force in 2013. Commenters and tax professionals are increasingly calling for the United States to enact a patent box regime of its own if it is serious about remaining competitive in the global marketplace.

This paper will first compare and contrast several of the current patent box models employed by European countries. In addressing these regimes, consideration will be paid to the effective tax rate provided by each, which forms of intellectual property qualify for preferential tax treatment, whether acquired intellectual property falls in to the patent box, what intellectual property-derived types of income receive a reduced rate of taxation, and any additional requirements a company must meet before qualifying for preferential tax treatment under the respective regimes. Additionally it will discuss whether other developed nations, most notably, the United States, should consider enacting patent box regimes to remain competitive in the global market. This discussion will address the potential positive and negative effects of such regimes and will consider the roll the regimes play in the greater tax competition debate. Finally, the paper will offer suggestions, based on the available empirical evidence regarding the effects of patent box regimes, for how other nations may structure their own patent box tax legislation to remain competitive in the global race for innovation.

B. Patent Boxes Background

Patent box tax regimes (whose name is derived from the box corporations must check on their tax form to qualify for the preferential tax rate) are the product, in part at least, of countries’ intense desires to encourage corporations to engage in innovative research and development and commercialization activities within their domestic borders. Modern economies are based more on innovation and intellectual property than ever before, and countries seeking to obtain or retain a competitive economic advantage in today’s global economy must find ways to encourage corporations in high-wage, innovation-based industries to remain in, and continue to obtain patents within, their borders. Patents are

3. Id. at 4, 7-8.
5. Atkinson & Andes, supra note 1, at 1.
6. Id.
considered by many to be the “lifeblood of society” and the “wealth of nations” and are highly sought after by developed nations.\(^7\) Unfortunately for national governments, patents are also highly mobile assets, and once a new innovation has been patented, the company holding it may be able move it offshore to a jurisdiction where the income from its commercialization will be taxed at a lower rate.\(^8\) In an effort to reduce the rate at which patents are moved offshore—or worse, the rate at which companies elect to incorporate in foreign locations—several countries have enacted patent box tax regimes that provide highly competitive tax rates for income derived from the commercialization of patents held within the country.\(^9\) Patent boxes may be seen as the logical follow-up to the research and development tax credits currently offered by many countries: while the research and development credits serve to incentivize activities that are likely to result in innovation, patent box regimes serve to entice innovative corporations to exploit such innovations within the country.\(^10\) For instance, if a given startup company intends to expend significant capital developing a new mobile communications technology, the cost of developing that technology will generally provide the developing corporation with some kind of tax benefit, typically in the form of a tax deduction or a tax credit.\(^11\) In a country that has enacted a patent box tax regime, some or all of the income subsequently derived from the commercialization of that technology, such as licensing and royalty fees or the production of goods utilizing the patent, will be taxed at a rate considerably lower than the ordinary corporate income tax rate for that country.\(^12\) Such countries appear to have a considerable advantage in recruiting new innovative businesses and retaining current domestic corporations that regularly participate in such innovative activities.

Although the Netherlands and Belgium first enacted their patent box regimes in 2007 and are frequently cited as the birthplaces of patent box taxation,\(^13\) the Republic of Ireland first offered a form of patent box taxation in 1973.\(^14\) Section 34 of Ireland’s Finance Act 1973 provided that “[a] resident of the State . . . shall be entitled to have any income from a qualifying patent . . . disregarded for all the purposes of the Income Tax Acts.”\(^15\) Generally, the provision exempted all royalty and licensing income arising from patented goods from the Irish taxpayer’s income tax.\(^16\) Ireland retained some form of its patent box regime until 2011, when it abolished the corporate tax incentive as a part of its National Recovery Plan 2011-2014, a plan designed to alleviate growing economic concerns and reduce increasing budget deficits.\(^17\) Today, eight countries utilize patent box tax regimes,
including Belgium, China, France, Hungary, Luxembourg, the Netherlands, Spain, and Switzerland. Additionally, the United Kingdom is actively in the process of enacting its own patent box legislation, which is currently set to go into effect in 2013. This paper will compare and contrast the structures of the patent box regimes enacted by Belgium, Luxembourg, the Netherlands, and the proposed United Kingdom plan and will address the immediate and potential effects of those regimes.

II. Four Patent Box Regimes

A. Belgium

The Belgian Patent Box, also known as the “deduction for patent income,” was established by the Belgian government in 2007 and codified in Articles 205/1 through 205/4 of the Belgian Income Tax Code. The patent income deduction regime allows companies to deduct from their taxable income 80 percent of their gross qualifying patent income. Consequently, only 20 percent of the taxpayer’s gross patent income is taxed at the statutory corporate tax rate of 33.99 percent. This structure yields an effective income tax rate of 6.8 percent on profits arising from patents.

The Belgian preferential patent income tax regime is available not only to Belgian corporations, but also to any company that is subject to either Belgian corporate income tax or Belgian non-resident corporate income tax (i.e., a Belgian permanent establishment of a foreign company). The deduction applies to gross income from patents or supplementary protection certificates owned by the Belgian company or Belgian permanent establishment because of its own development activities at a qualifying research and development center located either in Belgium or abroad. The Belgian patent box regime requires the research and development centers at which the patents are developed to set forth the plan to abolish the tax exemption for patent royalties, the royalty exemption was not officially abolished until the passing of section 26 of Finance Act 2011. See Finance Act 2011 (Act. No. 6/2011) (Ir.) § 26, available at http://www.irishstatutebook.ie/pdf/2011/en.act.2011.0006.pdf.


19. CODE DES IMPOTS SUR LES REVENUS [C.I.R.] art. 205/1-4 (Belg.). Official versions of Belgian legislation are available only in French and Dutch. This paper will rely in part on English translations and interpretations of the Belgian statute provided by accounting, legal, and financial services companies. To the extent possible, multiple sources will be given to corroborate translations and interpretations.


22. Patent Income Deduction, supra note 20, at 1; Maxwell & Benesch, supra note 4. This effective rate is calculated by multiplying the amount of income available for taxation at the ordinary statutory rate by said rate (i.e., 20 percent multiplied by 33.99 percent). This rate, as well as those to be discussed under other regimes in this paper, represents the maximum effective tax rate for patent income provided by the Belgian Patent Income Deduction Regime, as other innovation-related tax credits, such as research and development credits, may further lower the rate. Patent Income Deduction, supra note 20, at 1. Such credits are beyond the scope of this comment.

23. Patent Income Deduction, supra note 20, at 1; Shanahan, supra note 2, at 5; Maxwell & Benesch, supra note 4.

qualify as a “branch of activity” of the business for the patent and its subsequent income to be eligible for the deduction. 25 Generally, a branch of activity is “an entity or a division of an entity that is capable of operating autonomously;” note, however, that there is no requirement that such research and development centers be located in Belgium. 26

The deduction is not limited to self-developed patents; it applies to income derived from patents acquired by the Belgian company or permanent establishment “in full ownership, joint ownership, usufruct, or via license agreement;” provided the company has further developed the patented product or process at a research and development center that, as above, qualifies as a branch of activity. 27 The research and development centers employed for such development activities need not be owned by the company owning, and subsequently exploiting, the patent; rather, the company is permitted to use contract research and development centers to further develop its acquired patents and to remain potentially eligible for the patent income deduction, provided that it retains the substance to perform and supervise such development activities at the center. 28 On the other hand, a Belgian company acting solely as such a contract research and development center for third-party companies that own and commercialize the related patents may not claim a deduction under the patent income deduction regime. 29

Patents and supplemental protection certificates are the only forms of intellectual property that qualify for the income deduction; know-how, trademarks, designs, models, secret formulas, and copyrights do not qualify for the deduction. 30 Additionally, a qualifying patent need not be granted by the Belgian government or the European Union; patents granted in other jurisdictions qualify as well. 31

The Belgian patent income deduction is applicable to income derived from both “(1) patents that are licensed [to a third party] by a Belgian company or a Belgian permanent establishment and (2) patents that are used in the manufacturing process of patented products [that is done by the company or in its name],” the latter of which is frequently referred to as “embedded patent income.” 32 For the former, the amount of income eligible for the deduction is based simply on the amount of royalties received. 33 The amount of the royalty income is limited, however, to the amount that is part of the company’s taxable income in Belgium and may not exceed the royalty that would have been agreed to between unrelated parties (i.e., the arm’s length price). 34 Therefore, a Belgian corporation may not license patented technology to a subsidiary or other related corporation at an unreasonable or overly inflated rate to claim a larger tax deduction.

The calculation of patent income when the company uses the patent to produce and sell patented goods is based on the hypothetical fee the company would have received had it

25. Stappen et al., supra note 24, at 291; Shanahan, supra note 2, at 5.
27. Shanahan, supra note 2, at 5.
28. Stappen et al., supra note 24, at 292-93; Shanahan, supra note 2, at 5.
29. Stappen et al., supra note 24, at 292-93; Shanahan, supra note 2, at 5.
30. Shanahan, supra note 2, at 5; Patent Income Deduction, supra note 20, at 2.
32. Stappen et al., supra note 24, at 293; see also Maxwell & Benesch, supra, note 4.
33. Patent Income Deduction, supra note 20, at 2; Shanahan, supra note 2, at 5.
34. Patent Income Deduction, supra note 20, at 2; Shanahan, supra note 2, at 5; Stappen et al., supra note 24, at 293. This arm’s length transaction fee is calculated based on a transfer pricing analysis under Belgian law. Patent Income Deduction, supra note 20, at 2.

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licensed the patent to an independent third-party company to manufacture the product itself. While the Belgian Tax Code does not explicitly address the methods a company may use in calculating this portion of the product’s income,13 “[i]n a recent decision, the Belgian Ruling Commission accepted the use of three different transfer pricing techniques to compute this portion: the costs, income and market approaches.”14 To be safe, the company may obtain a preliminary ruling from the Belgian Rulings Commission on a proposed pricing method prior to using that method to calculate its tax deduction under the patent box regime; doing so will allow the company to claim income as patent income without fear of the Belgian tax authorities later questioning the validity of the claim.15 Of note, however, is that capital gains realized on the disposal of an otherwise eligible patent are not covered by the Belgium patent income deduction regime.16

In sum, the Belgium patent income reduction regime provides Belgian companies or Belgian permanent establishments of foreign companies a 6.8 percent effective tax rate on income derived by the company or permanent establishment from the commercialization of its patents and supplemental protection certificates. The regime applies not only to ordinary patent income (that is, licenses and royalties), but also to patent income embedded in the sales price of patented products. Moreover, it applies to both self-developed patents as well as acquired patents, provided the latter have been further developed at a qualifying research and development center.

B. LUXEMBOURG

The Luxembourg patent box (also known as the IP box) was enacted by the Luxembourg government in December 2007 and codified in Article 50bis of the Luxembourg Income Tax Act.17 On March 5, 2009, Luxembourg tax authorities issued an administrative circular regarding Article 50bis of the Income Tax Act that was intended to clarify the rules regarding the IP box regime.18

The Luxembourg regime provides for an 80 percent exemption for net income derived from qualifying intellectual property.19 Consequently, only 20 percent of such income is taxable at the statutory corporate tax rate of 28.8 percent, yielding an effective tax rate of

13. Stappen et al., supra note 24, at 293.
16. Id. at 2; Eynatten & Brauns, supra note 36, at 43.
tual%20Property%20Tax%20Regime.pdf; Eynatten & Brauns, supra note 36, at 44.
5.76 percent. An important note is that the exemption applies to net IP income as opposed to gross IP-derived income. That is to say, the Luxembourg IP box generally applies, regardless of the type of commercialization, only to the difference between the gross revenue derived from the intellectual property and all expenses incurred in direct economic connection with such revenue, including, for the first year in which the exemption is claimed, the activated (i.e., capitalized) expenses incurred in past years (e.g., the present year’s amortization expenses, etc.).

The IP box regime applies to all Luxembourg taxable companies, including permanent establishments of foreign companies. A company need only economic ownership of the qualifying intellectual property to exempt net income from the commercialization of such intellectual property, and, in the event legal and economic ownership of the intellectual property are split, the company with economic ownership rights is the company that will benefit from such ownership.

The IP box regime’s exemption applies not only to self-developed intellectual property but also to acquired intellectual property rights, with no requirement for additional development. Intellectual property rights acquired from an “associated company,” however, do not qualify for the regime’s exemption. For the purposes of the IP box regime, an associated company is a “company in which the company benefiting from the intellectual property rights income has at least a 10 percent direct participation or is its direct shareholder of at least 10 percent. Or where both companies have a common direct shareholder of at least 10 percent.” Outside of the associated company limitation, however, the Luxembourg IP tax regime is not concerned with the source of the patent or other qualifying intellectual property right; it looks only to see who currently has economic ownership of the patent being exploited, not to who or where the intellectually property was developed.

The Luxembourg IP box applies to a wide range of intellectual property. The statute includes patents (including supplementary protection certificates), trademarks or brands, designs, domain names, models, and software copyrights. The subsequent Administrative circular expounds upon the list in the statute, providing that sports celebrities, for example, who commercialize products under their name or image may qualify for the regime as well.

The scope of income to which the IP box applies is similarly broad, applying to ordinary IP income (e.g., royalty and licensing fees from third parties); to embedded income

42. Shanahan, supra note 2, at 7; Maxwell & Benesch, supra note 4.
43. Luxembourg Intellectual Property Tax Regime, supra note 41, at 3; Maxwell & Benesch, supra note 4.
44. Luxembourg Intellectual Property Tax Regime, supra note 41, at 3; Maxwell & Benesch, supra note 4.
46. Eynatten & Brauns, supra note 36, at 44; Maxwell & Benesch, supra note 4.
47. Luxembourg Intellectual Property Tax Regime, supra note 41, at 2; Luxembourg: Clarification on IP Regime, supra note 40, at 2.
48. Shanahan, supra note 2, at 7; Maxwell & Benesch, supra note 4.
49. Eynatten & Brauns, supra note 36, at 44.
50. Id.; Shanahan, supra note 2, at 7.
(i.e., the value of the IP determined to be included in the sale price of a patented good); and even to capital gains income from any subsequent sales of the intellectual property rights. For the first category of IP income, the company is entitled to an 80 percent exemption of all net royalty income. As mentioned above, for these purposes the net income is calculated as the actual gross revenue from the commercialization of the patent or IP right—the actual royalties received, in this case—deducted by “all expenses incurred in direct economic connection with such revenue, including interest expenses from the financing of IP rights, amortization[,] and potential impairments recorded on each particular IP right.” The 2009 Administrative circular clarified the meaning of the word royalty, stating that the only royalties to which the box shall apply are those that meet the definition of royalty provided by the Organisation for Economic Co-operation and Development’s (OECD) Model Convention with Respect to Taxes on Income and on Capital. Article 12 of the OECD Model Convention defines royalties as “payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial[,] or scientific experience.” Therefore, a company seeking to apply the IP box’s 80 percent exclusion must ensure that its royalty income aligns itself with this provision.

In the event a company uses an intellectual property right for its own activities, such as the manufacture of a patented product, the Luxembourg IP box regime allows for a notional deduction of 80 percent of the income the company would have hypothetically received in the event it licensed the intellectual property right to a third party at an arm’s length basis. Finally, the IP box also allows for an 80 percent exemption for any net gains realized upon the sale or transfer of an eligible intellectual property right. Any expenses directly incurred in connection with the intellectual property right that have reduced its basis in the year of sale or any previous year will be recaptured upon alienation of the right and decrease the amount of the exemption up to an amount equal to 80 percent of the gain.

The 2009 Administrative circular provided clarification on the valuation of intellectual property rights when calculating capital gains or determining the value of a hypothetical arm’s length royalty transaction. It provided that in these situations, the taxpayer is permitted to use any generally accepted or commonly used international valuation method.
In sum, the Luxembourg IP box allows any Luxembourg taxpaying entity to exclude from its taxes 80 percent of all net income derived from the commercialization, including alienation, of a wide range of intellectual property rights, presently yielding a relatively low 5.76 percent effective tax rate for such income. The IP box applies to both self-developed and acquired intellectual property and requires only that the intellectual property not be acquired from an associated company and that all expenses directly related to the intellectual property be properly capitalized in the first year the benefit of the IP box regime is claimed by the taxpayer.

C. THE NETHERLANDS

The Dutch Patent Box Tax Regime was originally enacted in 2007, but in the Netherlands’ Tax Plan 2010, Dutch authorities significantly modified and expanded its patent box tax regime to remain competitive in the competition for foreign innovative businesses; the resulting tax regime became known as the Dutch Innovation Box. The relevant provisions of the Dutch Innovation Box are presently codified in Article 12b of the Corporation Tax Act 1969.

The Dutch Innovation Box provides Dutch taxpayers with a flat 5 percent effective tax rate on all net income derived from qualifying intellectual property. This effective tax rate represents a 50 percent decrease from the rate offered by the preceding patent box statute, which offered a flat 10 percent effective tax rate and approximately an 80 percent reduction of the statutory Dutch corporate income tax rate of 25.5 percent. As the phrase net income suggests, however, this favorable rate only applies to qualifying IP-derived income once such revenue exceeds the development costs associated with the innovation. Such losses related to qualifying intellectual property (e.g., accumulated development costs) are currently deductible at the statutory tax rate of 25.5 percent.

The Dutch Innovation Box includes a broad range of intellectual property. The regime applies to income derived from not only patents—which need not be granted by Dutch patent authorities but may instead be granted by any patent granting body—but
also from all innovations and activities to which a so-called R&D declaration (alternatively, an R&D certificate) is issued. R&D declarations, which are granted by an agency of the Dutch Ministry of Economic Affairs known as Agentschap NL, are generally issued to all technological innovations that are deemed by Agentschap NL to be sufficiently innovative, but cannot be patented, or for which the developing company deems a patent to be undesirable. This includes, but is not limited to, such activities as “software development, the development of more efficient corporate processes (such as production processes), and the development of all types of sustainable (resource) technology,” as well as trade secrets. The box does not apply, on the other hand, to such things as trade names, brands, or logos. As will be discussed later, the distinction between patented innovations and innovations for which R&D certificates are granted becomes important when considering the location of the related research and development activities and the related income to which the Innovation Box applies.

The Dutch regime generally applies only to self-developed intellectual property but may also be applied to acquired intellectual property components that the company further develops. Note, however, that the subsequent intellectual property, of which the acquired intellectual property was a part, shall include (for the purposes of determining the development costs threshold) the cost of the acquired intellectual property. Practically speaking, this means that the IP-derived income must exceed the cost of the acquired intellectual property plus additional research and development costs before the favorable Innovation Box tax rate may apply.

Additionally, the regime permits the Dutch company to outsource some of its research and development activities to contract research and development facilities and companies located in other jurisdictions, but the extent to which a company may do this and still qualify for the Innovation Box tax rate depends on whether the company holds a patent or an R&D certificate. For patented innovations, the Dutch statute merely requires that the research and development activities “take place for the risk and account of the Dutch taxpayer.” For innovations and intellectual property for which an R&D declaration is obtained, however, the taxpayer must meet one of two requirements with regard to development: the Dutch company commercializing the intellectual property right must have either (1) actually coordinated, supervised, and managed the outsourced research and development activities; or (2) performed at least 50 percent of the research and development itself in the Netherlands. The 50 percent threshold was intended by the Dutch government to be a safe harbor for companies wishing to be certain that their in-house and outsourced research and development activities would result in commercialization to

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69. Maxwell & Benesh, supra note 4; Shanahan, supra note 2, at 6.
70. Maxwell & Benesh, supra note 4; Munting & van der Wal, supra note 66, at 2.
71. Munting & van der Wal, supra note 66, at 3; Shanahan, supra note 2, at 6.
72. The New Dutch Innovation Box, supra note 64, at 1; Munting & van der Wal, supra note 66, at 3.
73. Maxwell & Benesch, supra note 4; Munting & van der Wal, supra note 66, at 3.
74. Munting & van der Wal, supra note 66, at 3.
75. Id.; Nijhof & Kloes, supra note 65, at 70; Shanahan, supra note 2, at 6.
76. Nijhof & Kloes, supra note 65, at 70; Shanahan, supra note 2, at 6.
77. Id., at 7; Nijhof & Kloes, supra note 65, at 70; Shanahan, supra note 2, at 6.
78. Munting & van der Wal, supra note 66, at 3; Nijhof & Kloes, supra note 65, at 70; Shanahan, supra note 2, at 6.
which a favorable tax rate may apply.\textsuperscript{79} The determination of how much of the research was conducted by a given firm and in a given jurisdiction is generally made using arm’s length transfer pricing principles.\textsuperscript{80}

The Innovation Box applies broadly, and perhaps somewhat vaguely, to all income and economic benefits derived from the innovative asset.\textsuperscript{81} This includes “licensing the patents, using the intangible assets in one’s regular business operations, and selling the intangible assets” (e.g., capital gains on the alienation of an intellectual property right).\textsuperscript{82} One notable requirement regarding the income to which the regime may apply is that for patented intellectual property, “more than 30 percent of the derived income should be attributable to the patent right.”\textsuperscript{83} Regardless of the type of income, determinations regarding the portion of income attributable to the qualifying intellectual property are made using standard arm’s length transfer pricing principles.\textsuperscript{84} The Dutch government strongly recommends—but does not require—that companies meet individually with Dutch tax authorities to arrive at advance agreements regarding such issues as whether a given intellectual property asset falls within the scope of the Innovation Box, what portion of income should be allocated to the qualifying assets, and whether transfer pricing principles have been satisfactorily applied.\textsuperscript{85} In an effort to facilitate such preliminary negotiations and agreements, the Dutch authorities have established a dedicated team to deal with Innovation Box rulings.\textsuperscript{86}

In sum, the Netherlands’ modified Innovation Box tax regime provides Dutch taxpayers with a comparatively low effective tax rate of 5 percent on income beyond a certain threshold (i.e., the cost of developing the intangible) that is derived from a wide range of intellectual property rights. The regime permits the taxable Dutch entity to conduct at least some of its research and development activities in foreign jurisdictions or through the employment of third-party contract research and development companies, and, to facilitate the process of qualifying for the regime, Dutch tax authorities have set up a dedicated team to issue advance rulings.

D. The U.K.’s Proposed Patent Box

Expressing its commitment to “creating the most competitive tax system in the G20,” and stressing its belief that patents have a “particularly strong link to high-tech Research and Development . . . and manufacturing activity,” the Government of the United Kingdom in November 2010 announced pending reforms to its taxation of innovation and intellectual property, including the forthcoming addition of a patent box tax regime.\textsuperscript{87} In

\textsuperscript{79} Nijhof & Kloen, supra note 65, at 70.
\textsuperscript{80} Id.
\textsuperscript{81} The Patent Box Will Become the Innovation Box with an Effective Tax Rate of 5%, KPMG Meijburg & Co. 1 (Sept. 2009), http://us.kpmg.com/microsite/TNF-Europe/2009/Sep/Innovation_Box.pdf.
\textsuperscript{82} Id.
\textsuperscript{83} Shanahan, supra note 2, at 6. This limitation only applies to patented innovations and not to those innovations that have been granted an R&D declaration. See id.
\textsuperscript{84} Munting & van der Wal, supra note 66, at 4; Maxwell & Benesch, supra note 4.
\textsuperscript{85} Maxwell & Benesh, supra note 4.
\textsuperscript{86} Shanahan, supra note 2, at 6.
June 2011, Her Majesty’s Treasury released its consultation on the proposed patent box tax regime, a detailed report explaining the purpose, goals, structure, and mechanics of the proposed plan, which, in the following months, was subject to criticism and comments from the international business community. Subsequently, in December 2011, Her Majesty’s Treasury released its response to the consultation in which it addressed such criticisms and set forth any changes it would make to the regime as a result of the responses it received to the consultation. The Treasury closed the comment period on February 10, 2012 and plans to include a final version of its patent box regime in the Finance Bill 2012, which will ultimately take effect in April 2013.

The United Kingdom’s proposed patent box plan is based on four so-called design principles: (1) a broad scope, (2) a formulaic approach, (3) an application to profits and not receipts, and (4) benefits for active ownership and innovation rather than acquisition and mere passive holding. The patent box proposal allows companies to apply a flat 10 percent effective tax rate to all qualifying net profits attributable to patents. This rate represents a 60 percent decrease from the United Kingdom’s 2012 Main Rate of Corporate Tax of 25 percent. The regime will potentially be applicable to all businesses “within the scope of [United Kingdom] corporate tax[ation]” that will have the opportunity to elect to receive the reduced rate of taxation as allowed under the regime. The 10 percent rate of taxation will not apply to losses, which will remain fully deductible at their ordinary rate of taxation; but, in an effort to maintain symmetry in the tax system, the patent box tax rate will only be applied to qualifying income to the extent that it is greater than any patent box losses or expenses (i.e., net IP-derived income). Additionally, any expenditure surpluses will be deducted from the patent box revenues of other group companies in the same period and any remaining losses will be carried forward and offset against future qualifying profits.

The proposed U.K. patent box includes not only patents, but also applies to supplementary protection certificates, which extend the protection provided by a patent for innovations in the pharmaceutical and agrochemical industries, as well as certain other non-patentable intellectual property rights, such as regulatory data protection and plant variety protection.
The patent box will not, however, apply to other forms of intellectual property, such as trademarks or copyrights, because the U.K. Government does not feel that such forms of intellectual property have a strong enough link to the high-tech activities to which the regime is intended to appeal. In its original consultation, the Treasury stated its intention that the patent box regime apply only to patents and supplemental protection certificates granted by the U.K.'s Intellectual Property Office or the E.U. Patent Office, as it feared other patent granting authorities may be willing to grant patent rights to innovations to which the Intellectual Property Office or European Patent Office would not generally grant a patent. But, in light of the response it received to this measure, the Government is currently compiling "a list of other [E.U.] Member States that have patent regimes with comparable patentability criteria and search and examination practices to the United Kingdom], with the intention of extending the Patent Box to include [patents granted under] those regimes."

The proposed U.K. patent box regime applies to companies that hold legal ownership of a qualifying intellectual property right, hold an exclusive license to a qualifying intellectual property right, or, in the event the right is held centrally in a group, where there is a group agreement which confers to one of the companies therein the rights to use sell or license the right. Additionally, the U.K. regime applies to both self-developed and acquired qualifying intellectual property rights, but the latter is subject to a development test. The development test, as amended in the response to consultation, requires that acquired intellectual property rights be further developed by the acquiring group or company. In an effort to simplify regime qualification while still keeping passive intellectual property holding companies beyond the scope of the patent box regime, the Treasury provided in its consultation response that a company will qualify for the U.K. patent box if for substantially all of its IP rights it has either developed the IP itself, or it performs a significant amount of the management activities," which for these purposes “will mean formulating plans and making decisions in relation to the development or exploitation of the IP rights.” These rules provide, then, that a company or group may subcontract its intellectual property research and development activities, provided it meets the management activities test set forth above.

Keeping with the broad scope design principle, the U.K. patent box will apply to a wide range of income types. The proposed plan will apply to income from royalty and licensing fees, embedded income in the sale of patented goods, income from the alienation of a qualifying patent, and damages paid by a third party in a lawsuit for infringing a patent right. Additionally, in circumstances in which it is deemed appropriate (e.g., where it is deemed that a hypothetical third party would have been willing to pay a fee to

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98. Id.
99. Id. at 9.
100. Response to Consultation, supra note 89, at 10.
101. Id. The latter provision relating to group ownership arrangements was added in the consultation response and is subject to further amendment. See id.
103. Id.
104. Id.
106. Id.
use the patent or other intellectual property in the manner in which the company is using it), income from the sale of goods manufactured using patented processes and income from services will be included in the patent box calculation at an arm’s length basis.  

Arguably, the most notable, and perhaps the most controversial, feature of the U.K. patent box is its use of a formulaic approach to calculating qualifying patent box profits. Rather than requiring companies to make a vaguely-guided arm’s length analysis of each patent transaction that yields income for the company, Her Majesty’s Treasury has instead attempted to simplify and clarify the process by delineating a three-stop formulaic model to determine the total qualifying innovation-based income.

The first step in the U.K. model is to calculate how much of the company’s total net profit for the period is attributable to patents and other qualifying intellectual property. To do this, the company’s expenses and taxable profit must be apportioned pro-rata into potentially qualifying patent-related income (i.e., income generally attributable to the revenue sources identified above) and non-patent income. Recognizing that making such a pro-rata split may be excessively difficult or unfeasible for some companies, the U.K. regime alternatively permits some companies to determine this amount by allocating income and expenses to various “divisions” of the company using a “just and reasonable basis.”

The second step in the model is to deduct from the net patent-related income an amount attributable to routine activities of the enterprise. This deduction is made by subtracting 10 percent of the company’s expenses from the net patent-related income calculated in the first step. The result of this calculation is the residual income, or the amount of the company’s total patent-related income that is attributable to the patented intellectual property of the company and no other non-IP-based value-adding activities embedded in all of the company’s products and services. The final step recognizes that other forms of intellectual property—namely, brand names—contribute considerably to a given company’s income and must be deducted from the residual income; therefore, this step requires that a company “with marketing intangibles that contribute 10 [percent] or more of their residual profit will be required to calculate an arm’s length royalty for the use of those intangibles in generating qualifying income.” This amount, the amount that represents the portion of residual income derived from brand name and other such intangibles, will be taxed at the ordinary corporate tax rate, and the remaining amount is the amount of income deemed to be attributable directly to patents and will be taxed at

107. Id. at 14.
108. See id. at 17.
109. Id.
110. See id.
111. Id.; Response to Consultation, supra note 89, at 11. The Government originally intended for companies using the “divisionalisation” alternative to step one to use transfer pricing methods to allocate its income and expenses to divisions of the business; however, responses to the consultation suggested that such an approach may be too complicated for many companies, so Treasury revised the approach in its response to allow for allocation on a “just and reasonable basis.” Response to Consultation, supra note 89, at 7, 11.
112. Patent Box Consultation, supra note 87, at 17.
113. Id.; Response to Consultation, supra note 89, at 11. The percentage markup was originally intended to be 15 percent, but the Treasury, recognizing that this rate may be excessive, reduced the rate to 10 percent in the consultation response. Response to Consultation, supra note 89, at 11.
114. Patent Box Consultation, supra note 87, at 17.
115. Response to Consultation, supra note 89, at 11.
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the incentivized rate of 10 percent.\textsuperscript{116} Again, recognizing that this step may be too complicated for smaller companies, the regime includes a safe harbor for smaller companies whose profits fall below £1 million; for such companies, the government will assume that 25 percent of their residual income is derived from non-qualifying intangibles and the remaining 75 percent shall be taxed at a rate of 10 percent.\textsuperscript{117}

In summation, the U.K. patent box proposal provides all U.K. corporation-tax-paying businesses with a flat 10 percent tax rate on all net income derived from self-developed or acquired and subsequently developed patents and supplemental protection certificates, with the caveat that the patents or certificates must be granted by the United Kingdom or other qualifying European Union patent-granting offices. Though the regime requires development of the patent, its standards are relatively loose and permit a company to outsource its research and development, provided it maintains a minimum level of managerial control over the activities. The regime applies broadly to a wide range of patent-related income, and, finally, provides taxpayers with a formulaic three-step model for calculating what portion of their income qualifies as patent-derived.

E. A COMPARISON OF THE PATENT BOX REGIMES IN LIGHT OF THE GOALS OF THE REGIMES

1. Effective Tax Rates

Of the four patent box regimes compared, the Dutch Innovation Box provides the lowest effective tax rate of 5 percent.\textsuperscript{118} This rate represents 50 percent of the proposed—but almost certain—U.K. patent box rate of 10 percent,\textsuperscript{119} 86.81 percent of the current Luxembourg rate of 5.76 percent,\textsuperscript{120} and 73.53 percent of the current Belgian rate of 6.8 percent.\textsuperscript{121} In fact, the Dutch Innovation Box rate is the lowest patent box tax rate in the world, with all other current patent box effective rates ranging from 5.76 percent to the 15 percent rate offered by the French and Spanish regimes.\textsuperscript{122} Additionally, of the regimes considered herein, only the Dutch and proposed U.K. patent regimes provide flat effective tax rates, while the regimes in Belgium and Luxembourg offer incentivized rates in the form of a deduction from the ordinary corporate income tax rate.\textsuperscript{123} This suggests that patent income rates in the latter two regimes are perhaps more susceptible to fluctuations, as their effective rates are directly tied to their ordinary corporate rates, whereas the former two regimes may continue to provide steady rates despite potential changes in their respective country’s ordinary corporate tax rates.

\textsuperscript{116} See id.
\textsuperscript{117} Id.
\textsuperscript{118} Shanahan, supra note 2, at 8.
\textsuperscript{119} Id.
\textsuperscript{120} Id.
\textsuperscript{121} Id.
\textsuperscript{123} Shanahan, supra note 2, at 8.
2. Scope of Intellectual Property Covered

Consideration of the scope of intellectual property that qualifies for the various regimes actually involves addressing two distinct aspects of the boxes: (1) which types of intellectual property qualify and (2) the extent to which acquired or third-party developed intellectual property qualify. In general, the Belgian patent income deduction regime and the proposed patent box regime in the United Kingdom cover considerably fewer types of intellectual property than the regimes in Luxembourg and the Netherlands. The former two regimes generally apply only to patents and supplemental patent certificates, while the Luxembourg regime extends its preferential rate to patents, supplemental patent protection certificates, trademarks, brands, designs, domain names, models, and software copyrights, and the Dutch Innovation Box extends broadly to all those innovations that the Dutch Ministry of Economic Affairs deems sufficiently innovative to the corporation itself. While at first glance it appears that the Belgian and U.K. regimes are simply not competitive when it comes to patent box scope, when considering the innovations covered by a regime, one must recall the general purpose of a patent box: to encourage innovative and high-tech companies to conduct substantial research and development activities in a given country and to subsequently commercialize the resulting patents through extensive manufacturing in said country. In light of this aim, one may argue that the inclusion in a patent box regime of such things as trademarks or new software does little to further the ultimate purpose of the regime, as such innovations are considerably less likely to lead to substantial technical research and subsequent manufacturing than patents and supplemental protection certificates.

None of the tax regimes considered herein completely bars income from acquired intellectual property from their patent box. That said, of the four, only the Luxembourg IP box allows for income derived from acquired intellectual property to be taxed at the preferential rate without the requirement for additional development. The other three regimes all have some requirement that the acquiring company further develop the patent or intellectual property before commercializing it and claiming subsequent income under the patent box. Of the three regimes requiring further development, only the Dutch regime requires that any of the subsequent development occur within domestic borders (and this requirement is not so much a requirement but a safe harbor provision). Both the United Kingdom and Belgium generally permit all further development to occur in foreign jurisdictions. The four regimes are essentially on a level playing field when it comes to their treatment of acquired intellectual property; while three of them require

124. Shanahan, supra note 122, at 15.
125. Id.
126. Eynatten & Brauns, supra note 36, at 144.
127. See Maxwell & Benesch, supra note 4. Recall that this generally includes a wide range of innovations including corporate processes and software development but does not extend to brand names, trademarks, and logos. See Shanahan, supra note 122, at 15.
128. PATENT BOX CONSULTATION, supra note 87, at 3, 5.
129. See id. at 6.
130. Shanahan, supra note 122, at 16.
131. Id.
132. Id.
133. Nijhof & Kloes, supra note 65, at 70.
134. Shanahan, supra note 122, at 17.
some additional development acquired intellectual property, none has any strict requirement establishing the extent to which the patent must be further developed, and further, none requires such further development to lead to the granting of a new patent. Considering, again, the two goals of a patent box regime—domestic research investment and substantial subsequent commercialization (i.e., manufacturing)—allowing income derived from acquired patents to be taxed at a preferential rate, without the requirement for substantial additional domestic development, seems to fail to achieve the former goal of a patent box regime. This concession could permit a domestic company to simply purchase intellectual property from a third party, outsource the property for minimal additional development, then commercialize the property and take advantage of the patent box’s preferential tax treatment without any real research and development expenditures in the country granting the preferential treatment. In theory then, while each of the regimes included in this comparison and, in fact, nearly every other patent box regime in the world, is on, essentially, a level playing field with regard to its treatment of acquired and foreign-developed intellectual property, a model could theoretically be adopted that would better tie the patent box to domestic research and development activities.

3. **Income Subject to Patent Box Rates**

Similar to the scope of the intellectual property comparison above, a discussion of the extent of income covered by each regime includes a consideration of two separate aspects of the regimes: (1) the types of income to which the patent box applies (e.g., royalty income, embedded income, capital gains income) and (2) whether the box applies to gross or net income. The proposed U.K. patent box regime currently applies to the widest range of income. It broadly applies to royalty and licensing income, embedded income in the sale of patented goods (including, in some cases, the sale of goods created using a patented process), capital gains income, income resulting from a lawsuit for patent infringement, and income from patented services. While it is possible that applying the patent box tax rate to such a wide range of income could work to offset the relatively high effective tax rate afforded taxpayers by the proposed regime, this would only be the case for taxpayers that develop and licenses new technology, for example, would not benefit from the wider range of income included in the proposed U.K. regime and would likely opt to develop and hold its intellectual property in a country with a lower patent box rate.

Both the Dutch Innovation Box and Luxembourg IP Box apply to royalty income from licensing qualifying intellectual property, intellectual property income embedded in the price of manufactured goods, and income from the sale of qualifying intellectual property. The Belgian patent income deduction regime, on the other hand, applies to the fewest types of income, applying only to royalty income and embedded patent income; the

135. *Id.* at 16.
136. *Id.* at 16-17.
137. *Id.* at 15-17.
regime is the only one considered in this paper to not include income from the sale of qualifying intellectual property.\(^\text{140}\)

Of the four tax regimes considered in this paper, the Belgian regime is the only one that applies to gross qualifying income.\(^\text{141}\) Each of the other regimes applies only to net qualifying income; thus, qualifying income is taxed preferentially only to the extent it exceeds the costs of developing the related patent.\(^\text{142}\) For companies whose research and development costs are substantial and the extent of future profits is questionable, the Belgian regime may be preferable as it allows those companies to receive a reduced tax rate even if the often substantial costs of developing the intellectual property have not yet been recouped.

4. **Final Comparative Thoughts**

Commenters have suggested that, in its current form, the proposed U.K. patent box regime is not competitive with those regimes presently enacted in Belgium, the Netherlands, and Luxembourg (commonly called the Benelux regimes).\(^\text{143}\) The proposed regime has been criticized for three distinct shortfalls: (1) an effective rate too high to draw in foreign investment, (2) application to a limited selection of intellectual property, and (3) a formulaic approach that will likely end up complicating the regime more than making it clear and easy to implement.\(^\text{144}\) The Benelux regimes, on the other hand, are much more competitive with one another, with each possessing its own relative strengths and weaknesses. The Belgian patent income deduction regime has a slightly higher effective tax rate than the other two Benelux regimes, but it is the only regime in the group to apply to gross patent-derived income.\(^\text{145}\) The Dutch regime’s biggest strength is that the tax rate provided by the regime is lower than any other patent box tax rate in the world.\(^\text{146}\) The Luxembourg regime combines a very competitive sub-six percent tax rate with coverage of the widest range of intellectual property, including trademarks and brand names.\(^\text{147}\)

Perhaps the most notable weakness of all four regimes is that each permits some, if not all, of the associated research and development to occur offshore. While each claims to increase research and development and commercialization activities in the taxing country, the fact that each allows for offshore development and preferential tax treatment of licensing income paints a different picture. Under all of the regimes considered in this paper, a company could theoretically purchase patents from a third party, contract with a research and development company in a foreign jurisdiction to have the patents marginally further developed, and then hold the patent in the patent box country and license it to other companies for subsequent manufacturing. In doing so, the hypothetical company would

\(^{140}\) Id. at 16.  
\(^{141}\) Id. at 15.  
\(^{142}\) Id.  
\(^{144}\) Eynatten & Brauns, supra note 36, at 45.  
\(^{145}\) Shanahan, supra note 122, at 15.  
\(^{146}\) Id.
be able to take advantage of a patent box regime without conducting any research and development or participating in any manufacturing activities in its domestic country. As one analyst remarked of the U.K. patent box regime, “it is really only an incentive for holding patent rights. Job creation is optional.” The reason for this seemingly obvious shortfall is simple: The European Union prohibits member nations from conditioning commercialization incentives on the performance of research and development within that nation. In fact, at one time, Ireland’s now-extinct patent box required that the research and development giving rise to the patent be conducted in Ireland. In 2007, however, the European Union ruled that Ireland’s patent box regime was “contrary to Articles 43, 48 and 49 of the [European Commission] Treaty” and formally requested that Ireland change its law. Therefore, as a result of these four nations’ membership in the European Union, they have been limited in the extent to which they could enact optimal patent box legislation.

III. Considerations in Whether the United States Should Adopt a Patent Box Regime

A. Preface

Recently there have been calls from both international fiscal policy organizations and notable tax commenters for the United States to adopt a patent box tax regime if it is serious about remaining competitive in the global marketplace and resuming its position as the dominant country in the high-tech innovations and manufacturing industries. Additionally, in a recent report before the House of Representatives Ways and Means Committee, the Joint Committee on Taxation expressed concern over the rate at which multinational companies that develop and receive patents in the United States are subsequently moving their patents to off-shore jurisdictions where the commercialization of such patents would not be nearly as expensive from a taxation standpoint. Research suggests that though the United States presently remains reasonably competitive in terms of levels of domestic high-tech innovation, it is quickly falling behind its competitors as evidenced by its relative rate of innovative progress over the last decade. That is to say, while the United States is currently competitive in the market for innovative businesses, its once dominant position is slowly eroding as the rest of the world takes steps to create a more enticing environments for innovative businesses.

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148. Sullivan, supra note 144, at 1307.
150. Id.
152. E.g., Atkinson & Andes, supra note 1, at 17-19.
153. STAFF OF THE J. COMNL ON TAXATION, 111TH CONG., PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING, at 13 (Comm. Print 2010).
Certainly the enactment of patent box legislation appears to be a possible solution to the U.S. innovation and manufacturing crisis, but several factors must first be considered before ultimately determining that a patent box tax regime is the proper answer to the problem. First, one must consider the overall international tax competition debate and determine whether participating therein is the proper solution to any fiscal concern. Next, attention must be given the actual effects of the currently available patent box tax regimes, as theoretical benefits do not necessarily yield real world advantages. Third, consideration must be paid any additional benefits beyond the scope of present patent box research the United States could realize from the enactment of a patent box regime. Finally, one must consider how a U.S. patent box could theoretically be structured to best address the concerns of tax commenters and the Joint Committee on Taxation.

B. INTERNATIONAL TAX COMPETITION TO WHAT END?

A discussion and analysis of the various patent box tax regimes and the possibility of enacting such a regime in the United States would be incomplete if not considered within the wider context of the current international tax competition debate. Generally speaking, international tax competition occurs when national governments attempt to entice multinational enterprises to invest within the borders of that country through the use of attractive effective corporate tax rates. In other words, a competing government attempts to lure additional outside investment “by reducing its tax claims on any income generated from such investments, thus raising the investors’ post-tax returns.” This phenomenon of governments attempting to lure away investment from other nations using lower tax rates arose in the mid-1980s when technological innovations began increasing the mobility of corporate capital such that relocating capital from one nation to another became a relatively simple and painless process. Some commentators have proposed that intergovernmental tax competition may lead to beneficial pressure on inefficient government spending, or, similarly, that such competition may actually drive rates down to their actual optimal level that would otherwise not be reached because self-serving governments would maintain higher than necessary rates, which could ultimately limit economic growth and output. Many other commenters, however, have argued that this phenomenon, wherein countries will repeatedly attempt to “one up” one another with increasingly shrinking effective tax rates, will ultimately result in a “race to the bottom,” which, in turn, will result in severe “downward pressure on corporate income taxes [that] will lead to a loss of revenue, and thus provide a constraint on government activity.” To this end, commentators have suggested that patent boxes may simply be another tool of tax competition that could result in reduced tax revenues across the board and that tax cooperation

156. Id.
158. Roin, supra note 155, at 546.
160. Devereux et al., supra note 157, at 452.
may ultimately yield a more beneficial result for governments. A detailed discussion of the merits of the respective arguments of the tax competition debate is beyond the scope of this paper, as, for the time being, the reality of the situation is clear: despite calls for tax harmonization, intergovernmental tax competition is alive and well. And short of a select few European Union and Organisation for Economic Co-operation and Development rules designed to prevent what is deemed “unfair tax competition—such as the European Commission’s ruling on the Irish patent box discussed above, governments are reasonably free to adjust their tax rates as they see fit and are, in fact, expected by businesses to lower rates to remain competitive with other competitor nations in the global economy. For this reason, it makes sense that the United States must at least consider enacting patent box legislation if it wishes to remain competitive with the United Kingdom, the Benelux nations, and all other nations currently offering high tech innovative businesses a patent box regime as an incentive to hold and commercialize patents domestically.

C. Theoretical and Real World Effects of Current Patent Box Regimes

Given the novelty of patent box tax regimes, there is currently little in the way of empirical evidence as to the effects of those regimes on the tax revenues of enacting governments. The Institute of Fiscal Studies, however, recently published a briefing note in which the authors simulate the effects of the Benelux regimes and the proposed United Kingdom regime on the location of patents in various European nations and the estimated effects the regimes will have on various tax revenues of the European Countries and the United States. While the empirical data presented in this study lacks the detail to allow the drawing of any conclusions regarding the effects of individual patent box variables, such as effective rate or intellectual property scope, it is sufficient to draw preliminary conclusions regarding the big-picture effects of patent box regimes. The study found that the introduction of patent box regimes yields a noticeable increase in the country’s share of newly created patents. For instance, the authors estimate that following the introduction of the U.K. regime, the United Kingdom’s share of newly created patents will increase to 17 percent. By contrast, its share of newly created patents before the existence of the Benelux regime was 12 percent, and its share of these patents after the introduction of the Benelux regimes was 8 percent. Somewhat predictably, the study found that the introduction of patent box legislation leads to an increase in patent share, but as other countries introduce their own patent boxes, that share will recede, although will likely remain above pre-patent box levels. While this finding is both unsurprising and a seemingly promising result for patent box advocates, later findings in the study suggest that patent boxes, at least in their current form, may not be as effective as they are.

161. Griffith & Miller, supra note 13.
164. Id.
165. Id. at 7.
166. Id.
167. Id.
intended to be. The second major finding in the study relates to the effect of patent boxes on short-term tax revenue. The study, as it related to tax revenue, was bifurcated: first, it addressed the effect the Benelux regimes would have on tax revenue from income related to new patents across the European Union and the United States; and second, it considered the effect of adding the U.K.’s proposed regime would have on patent-related revenue in those same nations.\textsuperscript{168} The authors’ simulations provide that, following the introduction of the Benelux regimes, tax income strictly from new patent revenue fell drastically in each of the fifteen countries considered, with revenues related to new patents falling more than 50 percent in several nations and with the nations suffering from the largest decrease in patent revenue being those enacting the patent box regimes.\textsuperscript{169} This finding suggests that while patent boxes are likely to attract a greater share of new patents, the increase in patent applications is unlikely to come close to making up for the significantly reduced tax rate of income derived from those patents. The trend is predicted to continue as more patent boxes are introduced, with the study predicting that following the introduction of the U.K. patent box regime, tax revenues will decrease in every nation, with the United Kingdom suffering the largest decrease in revenue.\textsuperscript{170} These results present a startling, but not altogether surprising, conclusion: the continued introduction of patent box tax regimes is likely to lead to a decrease in new patent-related income in all developed nations, with the enacting nations experiencing the most significant immediate reduction in revenue.\textsuperscript{171}

While this early study does not paint a rosy picture for patent box regimes, there are several caveats that must be noted in considering the findings of the study. First, the study measures only the immediate static effects of enacting patent box legislation.\textsuperscript{172} That is, the study only contemplated two factors in calculating the potential tax revenue consequences of the patent box regimes: (1) effective tax rates and (2) share of new patents.\textsuperscript{173} The potential and desired consequences of patent box regimes, however, is not merely to increase revenue directly from taxes on patent income by increasing patent income to a large enough extent to overcome the reduced tax rate, but rather to drive the economy as a whole by increasing employment and high-tech exports and encouraging additional research, development, and innovation efforts in the nation.\textsuperscript{174} These potential outcomes are not modeled in this study, and in fact, are likely particularly difficult to study empirically in this context given the novelty of patent box regimes and the sheer number of variables that play a role in achieving those outcomes.\textsuperscript{175}

In addition, the study fails to account for another frequently stated benefit of patent box regimes—the domestic market may bear a higher tax rate on relatively immobile, location-specific income if such a rate is supported by a significantly reduced tax rate on income from more mobile assets, such as patents and intellectual property.\textsuperscript{176} In other words, proponents contend that a government may be able to maintain a relatively high

\textsuperscript{168} Id. at 10.
\textsuperscript{169} Id. at 11.
\textsuperscript{170} Id.
\textsuperscript{171} See id.
\textsuperscript{172} Atkinson & Andes, supra note 1, at 10.
\textsuperscript{173} Griffith et al., supra note 163, at 11.
\textsuperscript{174} Atkinson & Andes, supra note 1, at 10.
\textsuperscript{175} See id. at 11.
\textsuperscript{176} Id.
general corporate tax rate by providing companies with a lower rate of taxation on mobile asset-derived income. The logic behind this argument is that companies displeased with the corporate tax rate in a given location can—and in fact will—relocate mobile assets to locations offering lower tax rates, but will likely be unable to relocate immobile or location-specific assets. This relocation of mobile assets to offshore locations then applies downward pressure on the corporate tax rate, as the domestic government struggles to make up for lost revenue from the assets transferred offshore. Instead of substantially reducing the general corporate tax rate to entice firms to repatriate their mobile assets, however, the government may lower the rate on income from only those mobile assets it seeks to bring back from foreign locations, thus relieving some of the downward pressure on the general corporate tax rate. This potential benefit is particularly relevant in a country like the United States, which has one of the highest corporate tax rates of all OECD nations and is currently subject to calls from tax commenters to reduce corporate tax rates to remain competitive with other OECD countries.

A final note regarding this preliminary patent box study—one which was conceded by the authors in a subsequent publication—is that the study fails to address how countries without patent boxes will fare in the future with regards to tax revenue as more and more countries enact patent box legislation. In the words of the authors: “in a world in which, say most European countries are expected to introduce some form of Patent Box, it is possible that tax revenues would fall even more if the [United Kingdom] did not introduce the Patent Box.” This leads to a realization that parallels the conclusion above regarding participating in intergovernmental tax competition: regardless of the likelihood that patent boxes will, at least in the short term, lead to noticeable reductions in tax revenue, the reduction that would likely follow a sustained failure to compete for mobile assets would likely exceed the predicted post-patent box reduction while providing none of the potential big-picture benefits of the patent box. That is to say, in light of the frequency in which the United States’ economic competitors are passing patent box legislation, not competing may simply not be an option. Instead of discussing the merits of whether or not the United States should enact a patent box regime, then, perhaps the discussion should center around determining how to design the best patent box.

D. THE U.S. PATENT BOX: MAXIMIZING BENEFICIAL OUTCOMES WHERE EUROPEAN REGIMES COULD NOT

In considering a potential ideal patent box structure for the United States, a key assumption will be made regarding the hypothetical U.S. patent box regime: the ultimate goals of such a regime would be both (1) to increase research and development activity within the United States and (2) to increase subsequent commercialization efforts within the United States. With this assumption in mind, there are at least two important elements that a U.S. patent box should possess to stand out in an ever-growing sea of similar

177. Griffith & Miller, supra note 13.
178. Id.
180. Griffith & Miller, supra note 13.
181. Id.
regimes: (1) a method of directly tying preferential taxation of patent-related income to domestic research and commercialization and (2) a reasonable level of simplicity. Note that in light of the lack of evidence regarding the effect individual aspects of a patent box, such as effective rate and scope of intellectual property, actually have on research and development and commercialization activities, it is virtually impossible to predict with certainty how the United States should address those aspects at this time. It can be said with some certainty, however, that a domestic research-commercialization link and simplicity would help a U.S. patent box in achieving its assumed goals.

As Robert Atkinson and Scott Andes stress in their 2011 report on patent boxes, establishing a connection between the reduced tax rate and domestic research and development and the commercialization of qualifying intellectual property would be pivotal in addressing the United States’ “noticeable state of [manufacturing] decline throughout the last decade.”

The closest and most obvious form of this linkage would be to simply condition receipt of the reduced patent box tax rate on a taxpayer’s conducting both the research and development giving rise to the patent and the subsequent manufacturing of patented goods in the United States.

Therefore, in order to qualify for the patent box regime, a company would have to establish that it conducted its research and development in the United States, or for acquired patents, that additional development occurred in the United States and that subsequent related manufacturing activities occurred in the United States. In the event the patenting company elects to not manufacture any goods with its new patent but rather licenses those patents to third parties, the company would only have to establish that the patents were developed and are currently held in the United States to qualify for the patent box. In either case, creating such a link between the preferential tax rate and domestic research and commercialization would allow the United States to mitigate potential revenue reductions and realize greater tangential benefits from its patent box in a way that no European nation has been able to do.

The other essential element of a potential U.S. patent box would be simplicity. There is currently a growing number of major businesses calling for reforms to the U.S. tax system to address the complexity of the tax code. These businesses—the very parties to whom the regime would be targeted—would be reluctant to take advantage of an unnecessarily complex patent box regime when simpler regimes are available overseas. In light of criticisms the United Kingdom has received for the formulaic approach it took to calculating qualifying income in its proposed patent box regime, the United States could simplify its patent box regime by using established transfer pricing methods to determine qualifying income and establishing dedicated panels of tax professionals to quickly provide rulings to businesses seeking to take advantage of the patent box regime. While such measures to simplify the regime would not, in and of themselves, ensure the success of a U.S. patent box, they would certainly be a substantial step in competing with those European and Asian boxes that are considered to be more complex.

As for the other elements of a potential patent box regime—of which there are many—it is simply beyond the scope of this article to attempt to predict how those should be structured. Absent substantial empirical evidence regarding how those elements affect a

182. Atkinson & Andes, supra note 1, at 18.
183. Id.
184. RATE COALITION, supra note 162.
185. Sullivan, supra note 144, at 1307.
patent box’s success, and in light of the extent to which such elements would likely be subject to the bidding of political lobbyists, predictions regarding such patent box aspects presently serve a very limited purpose. At this point, however, two things seem clear: (1) it is unlikely that the United States will be able to remain competitive in innovative industries if it does not enact a patent box and (2) the extent to which such a regime would achieve its desired goals would depend on the extent to which it connected tax benefits to domestic activities and on the extent to which businesses could take advantage of it without combaining significant complexity.

IV. Conclusion

There can be little doubt that patent boxes are shaping up to be the latest tool in the international competition to encourage domestic innovation and commercialization. In the last five years, nine nations have established patent box regimes, and those regimes—specifically those in the Benelux nations and the United Kingdom—have provided a blueprint upon which the United States can improve to re-position itself as the worldwide leader in high-tech research and manufacturing. To do so, a U.S. patent box would need to be reasonably simple while remaining competitive with its European counterparts in terms of effective tax rates, scope of income, and scope of intellectual property. But, more importantly, a U.S. patent box would need to establish a firm connection between the receipt of preferential taxation to domestic research and commercialization activities in a way the European regimes have been unable to do. Such a connection would ensure that the patent box does not merely become a haven for holding companies, but rather encourage the active development and commercialization of new intellectual property. In so enacting a patent box, the United States could address, in large part, the criticisms of both the academic and business communities regarding its declining international competitiveness and reestablish itself as a leader in innovation and manufacturing.