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How Should Foreign Banks Be Permitted to Engage in Nonbanking Activities within the United States?

By Douglas Landy and James Kong*

The authors argue that the Federal Reserve should adopt the 2019 Volcker Rule revisions as the standard for how foreign banks may engage in nonbanking activities within the United States.

In interpretive guidance issued over several decades, the Board of Governors of the Federal Reserve (the "Federal Reserve") has defined the circumstances under which activities engaged in by foreign banks subject to the Bank Holding Company Act of 1956 (the "BHCA")[1] is considered within or without the United States. This definition is important: the BHCA and its implementing regulations provide that such foreign banking organizations ("FBOs")[2] may engage in activities that are outside of the United States without the application of the BHCA's non-banking restrictions, even where, in certain cases, some of the activity takes place inside of the United States. The Federal Reserve has interpreted the boundaries of this jurisdictional line for decades, modifying it as needed to account for new structures and technologies.

On October 8, 2019, the Federal Reserve and four other federal agencies amended the Volcker Rule to simplify or eliminate certain unnecessary, unwieldy, and/or redundant requirements.[3] Among these changes were amendments to the requirements to utilize the "trading outside of the United States"

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1 12 U.S.C. § 1841 et seq. (2022).

2 An FBO is a foreign bank that operates or controls in the United States at least one of (i) a branch, agency or commercial lending subsidiary, (ii) a bank, or (iii) an Edge corporation (a United States corporation authorized to engage in activities outside the United States that are broader than those banks can engage in within the United States). 12 C.F.R. § 211.21(o) (2022). References to Regulation K in this memorandum generally refer to Subpart B of Regulation K, unless otherwise noted.

3 *See* Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20191008a1.pdf

exception to the proprietary trading restriction (otherwise known as "TOTUS").[4] While directed specifically at "financial instruments," as that term is defined in the Volcker Rule,[5] and therefore limited to the interpretation of the Volcker Rule, we believe that the Federal Reserve should adopt TOTUS as the established standard for all FBO nonbanking activity conducted pursuant to the provision in Federal Reserve Regulation K, which states that an FBO may "[e]ngage in activities of any kind outside of the United States."[6]

WHY THIS IS IMPORTANT?

The authority of FBOs to engage in activities under the laws of their home countries is often broader than their authority to engage in activities in the United States. Rather than forcing FBOs to change their businesses to avoid the United States, Congress provided FBOs with several means by which to engage in activities that have some contact with the United States. One such provision is in Section 4(c)(9) of the BHCA, which states, in pertinent part, that an FBO may acquire:

> shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of this chapter and would be in the public interest.[7]

From the above statutory provision, the Federal Reserve adopted a provision in Regulation K, which states, in pertinent part, that:

> **Permissible activities and investments.** A foreign banking organization that qualifies under paragraph (a) of this section may: (1) Engage

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[4] Mr. Landy is the purported originator of the acronym "TOTUS." *See* Corporate Governance Group Client Alert, https://www.milbank.com/images/content/1/5/15022/Milbank-Volcker-Rule-and-Foreign-Banks-Client-Alert.pdf (the first use of the term).

[5] We note that the Volcker Rule is codified as Section 13 of the BHCA, and general BHCA definitions, terms and interpretations should apply to Section 13 under general rules of statutory construction. *See* 12 U.S.C. § 1851.

[6] The Federal Reserve has been presented with this argument and (based on recollections provided to us) we understand that Federal Reserve Staff noted that the Volcker Rule "TOTUS" exemption was not intended to apply to Regulation K authorities more broadly. We note that while the Volcker Rule was issued by five federal agencies, the interpretation of Regulation K is done solely by the Federal Reserve.

[7] 12 U.S.C. § 1843(c)(9).

in activities of any kind outside the United States.[8]

This provision offers FBOs the ability to engage outside of the United States in activities not permitted for U.S. banks within the United States, as well as any other activities outside of the United States. As described below, the Volcker Rule, through TOTUS and pursuant to Regulation K, offers a broader path to engage in activities within the United States than does non-Volcker Rule transactions that are also conducted pursuant to Regulation K.

An open interpretive question for FBOs has always been how much of an activity can be performed within the United States for the activity to still be considered "outside" of the United States. We review the evolving answer to this question below. We believe that the TOTUS interpretation changes the nature of where the line should be drawn for FBOs between inside and outside the United States, and should permit additional activity within the United States in order to provide a consistent rule on this and related topics.

HOW THE FEDERAL RESERVE DEFINED "SOLELY OUTSIDE OF THE UNITED STATES" PRIOR TO THE 2019 VOLCKER TOTUS REVISIONS

Cross-Border Jurisdiction under Banking Law

The extra-territorial reach of U.S. banking law is notoriously broad. Under the BHCA, any entity that becomes or is treated as a bank holding company ("BHC")[9] is subject to the non-banking provisions of Section 4 of the BHCA and Regulation Y.[10] Those provisions heavily restrict the ability of a BHC to engage in non-banking activities within the U.S., and contain certain requirements for engaging in those activities outside the U.S. While the provisions of the partially repealed Glass-Steagall Act ("GSA")[11] were always held to end at the "water's edge," the BHCA and more recently the Volcker Rule were specifically designed to apply on a worldwide basis for all covered banking entities and only provide limited exceptions for FBOs to engage in non-banking activities outside of the U.S.

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[8] 12 C.F.R. § 211.23(f)(1).

[9] A BHC is any company that has control over any bank. 12 U.S.C. § 1841(a). An FHC is a BHC that meets certain additional financial and managerial criteria. 12 U.S.C. § 1841(p). FBOs that have branch or agency offices in the U.S. are treated as if they were BHCs for purposes of Section 4 of the BHCA and its nonbanking restrictions pursuant to Section 8 of the International Banking Act of 1978. 12 U.S.C. § 3106.

[10] *Id.*

[11] The Banking Act of 1933, Sections 16, 20, 21 and 32.

Specific Interpretations by the Federal Reserve Under the BHCA as to When an Activity Is "Outside of the U.S."

As noted, FBOs are subject to the BHCA, including the non-banking restrictions contained in Section 4.[12] Section 4 generally restricts BHCs, including FBOs treated as BHCs, from engaging in any activity that is not "closely related to banking,"[13] or if a financial holding company ("FHC"), from engaging in any activity that is not "financial in nature."[14] There are numerous exceptions to these restrictions for FBOs.

One such exception is available for FBOs that qualify as qualified foreign banking organizations ("QFBOs"), an analysis found in Federal Reserve Regulation K that determines whether a non-U.S. bank meets certain U.S. law requirements to be considered a "bank" for purposes of the BHCA.[15] An FBO that is a QFBO may generally engage in any activity outside the United States, even if such activity would require authority alternative to Regulation K (such as the authorities, discussed in the subsections below, under sections 4(c)(8) or 4(k)(1)(B) of the BHCA) if the FBO were to engage in those activities "in the United States."[16]

How does an FBO know if an activity is "outside the U.S."? Regulation K does not provide any further detail regarding what is considered to be conducted "outside the United States." However, it does define "engaged in activities" within the United States "to mean conducting an activity through an office or subsidiary in the United States."[17] The Federal Reserve has also issued a number of interpretations under both Regulation K and Regulation Y that may help determine where this line rests. From these interpretations, we can glean certain factors and how the Federal Reserve analyzes them. These Federal Reserve regulations and interpretations are instructive in assessing the bounds of permissible activity, and show the evolution of Federal Reserve analysis based on changing technology and business patterns.

Location Where the Service or Activity Is Provided

A 1971 interpretation by the Federal Reserve, which was later codified in Regulation Y, noted that a company would not be deemed to be engaged in

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[12] 12 U.S.C. § 3106.

[13] 12 U.S.C. § 1843(c)(8).

[14] *Id.* at § 1843(k)(1)(A).

[15] 12 C.F.R. § 211.23(a).

[16] *Id.*

[17] *See* Federal Reserve, Bank Holding Company Supervision Manual (Feb. 2020), at § 3510.0, p.5, available at https://www.federalreserve.gov/publications/files/bhc.pdf. *See also* 12 C.F.R. § 211.2(g).

activities in the United States "merely because it exports (or imports) products to (or from) the United States, or furnishes services or finances goods or services in the United States, from locations outside the United States."[18] This interpretation and the definition of "engaged in [U.S.] activities" under Subpart A of Regulation K[19] generally reinforce the notion that the Federal Reserve will look at the location at which the foreign banking organization is conducting the activity, rather than the location of the counterparty, to determine the location of the activity, even if the counterparty is in the United States.

Location of the Personnel Providing the Service or Activity

Additionally, while the Federal Reserve has not issued any broadly applicable interpretive guidance regarding the involvement of U.S. personnel in activities otherwise conducted entirely outside the United States under Regulation K, it has implemented Regulation K with respect to certain trading activities.

In particular, we believe the Federal Reserve's regulation implementing the Volcker Rule[20]—which represents the most recent instance in which the Federal Reserve has interpreted the contours of permissible activity pursuant to Regulation K—is instructive. The Volcker Rule (which generally prohibits banking entities from engaging directly or indirectly in proprietary trading) permits proprietary trading by FBOs provided that such trading is conducted "outside the United States." One of the conditions to utilizing the TOTUS exemption is that the FBO be a QFBO and that the activity be conducted pursuant to sections 4(c)(9) or 4(c)(13) of the BHCA—i.e., the exemptions implemented by Regulation K. Thus, every trade made by an FBO pursuant to TOTUS is also made pursuant to the provisions of Regulation K. A plain reading of this condition would therefore imply that trading activity outside the United States pursuant to the TOTUS exemption should necessarily be considered a permitted activity conducted outside the United States for purposes of Regulation K, including section 211.23(f)(1).

Importantly, under revisions to the Volcker Rule implemented in 2019, the Federal Reserve modified the requirements of the TOTUS Exemption to permit (i) trading with U.S. counterparties, and (ii) the involvement of U.S. personnel in arranging, negotiating or providing other services with respect to a transaction, so long as the principal risk of the transaction is booked outside of

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[18] 12 C.F.R. § 225.124.

[19] 12 C.F.R. § 211.2(g).

[20] 12 C.F.R. § 225 Part 248.

the United States and the decision-making personnel with respect to the transaction are based outside the United States.[21]

While these conditions were issued pursuant to the regulations implementing the Volcker Rule and do not explicitly apply with respect to other activities conducted pursuant to Regulation K, we note that the Volcker Rule is a provision of the BHCA, and we believe the updated regulations demonstrate that certain non-U.S. activities may involve U.S. counterparties or certain U.S. personnel, while still qualifying as an activity conducted outside the United States under Regulation K.[22] In other words, the Federal Reserve should make clear that Regulation K and the Volcker Rule are aligned in this aspect.

Effect of the Revised TOTUS Exemption

To the extent that these conditions appear to be less restrictive than certain positions that the Federal Reserve has taken with respect to Regulation K historically, we believe that the Federal Reserve should make clear that the TOTUS exemption, as expressed in the Volcker Rule, as it was amended in 2019, should supersede those historical positions. For example, we note that a 1982 Federal Reserve interpretive letter indicates that U.S. offices and subsidiaries of an FBO that participate in placing orders on domestic exchanges or accepting orders for placement on foreign exchanges by a non-U.S. subsidiary of the FBO would be considered to be engaged in business in the

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[21] 12 C.F.R. Part 248.

[22] In 2003, the Federal Reserve issued an interpretation stating that a foreign bank's underwriting of securities intended for distribution in the United States would be deemed a U.S. activity, even if the principal risk of the securities was booked outside of the United States. However, we believe this interpretation is applicable only to its facts for several reasons. Securities underwriting is subject to a number of specific banking law provisions that are not broadly applicable to other activities—for example, Regulation K specifically prohibits FBOs from engaging in underwriting in the United States in excess of certain limits unless otherwise authorized under the BHCA, and the Federal Reserve had further stated in adopting this provision that "no part of the prohibited underwriting process may take place in the United States and . . . the prohibition on the activity does not depend on the activity being conducted through an office or subsidiary in the United States." 12 C.F.R. § 211.605(c)(3). There is no analogous provision with respect to other activities. Furthermore, in issuing the 2003 interpretation, the Federal Reserve also noted that the FBOs in question were primarily using their U.S. offices to facilitate their underwriting activity and simply booking the principal risk in non-U.S. offices in an attempt to evade the restrictions under Regulation K. This implies that an FBO could safely comply with the requirements of the TOTUS exception by not engaging in such activity. As a result, we do not believe the 2003 interpretation should be more broadly applicable in interpreting the scope of U.S. and non-U.S. activity under Regulation K.

United States, and would therefore be prohibited from engaging in such activities absent the Federal Reserve's prior approval.[23]

However, this interpretation appears to contradict the Federal Reserve's regulation implementing the Volcker Rule, which, as noted above, allows FBOs to involve U.S. personnel in arranging, negotiating or providing other services with respect to transactions in financial instruments (such as securities and derivatives) pursuant to Regulation K. Given the foregoing, we believe FBOs should be able to engage in activities outside the United States that are conducted with U.S. counterparties or with certain assistance of U.S.-based personnel, provided that (i) the principal risk of the activity is booked outside the United States, and (ii) decision-making with respect to the activities or transactions is conducted by personnel outside the United States.[24]

WHAT TOTUS SAYS THE NEW STANDARD OUGHT TO BE

TOTUS, as revised, states the following, in relevant part:

> **§ [ ].6 Other permitted proprietary trading activities.**
>
> (e) *Permitted trading activities of foreign banking entities*. (1) The prohibition contained in § [ ].3(a) does not apply to the purchase or sale of financial instruments by a banking entity if:
>
> (i) The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of any State;
>
> (ii) The purchase or sale by the banking entity is made pursuant to paragraph (9) or (13) of section 4(c) of the BHCA; and
>
> (iii) The purchase or sale meets the requirements of paragraph (e)(3) of this section.
>
> (2) A purchase or sale of financial instruments by a banking entity is made pursuant to paragraph (9) or (13) of section 4(c) of the BHCA for purposes of paragraph (e)(1)(ii) of this section only if:
>
> (i) The purchase or sale is conducted in accordance with the requirements of paragraph (e) of this section; and
>
> (ii)(A) With respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking

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[23] *See* Letter from Michael Bradfield, General Counsel of the Federal Reserve, to A. P. Richard Carden (April 20, 1982).

[24] We note that there is little to no guidance as to how these two conditions may be satisfied.

> organization requirements of section 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c) or (e)), as applicable; . . .
>
> (3) A purchase or sale by a banking entity is permitted for purposes of this paragraph (e) if:
>
> (i) The banking entity engaging as principal in the purchase or sale (including relevant personnel) is not located in the United States or organized under the laws of the United States or of any State;
>
> (ii) The banking entity (including relevant personnel) *that makes the decision to purchase or sell as principal is not located in the United States* or organized under the laws of the United States or of any State; and
>
> (iii) The purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, *is not accounted for as principal* directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.[25] [Emphasis added]

The change from the original version of TOTUS is stark: FBOs are now permitted to engage in financial transactions as principals with U.S. counterparties so long as the principal risk is booked outside the United States and the material decisions regarding the transaction are made outside of the United States. In particular, the use of U.S. personnel to administer, negotiate or execute a transaction no longer make the transaction a U.S. transaction for purposes of the Volcker Rule. There do not appear to be any compelling policy reasons to not apply the TOTUS standard to transactional activities conducted pursuant to Regulation K; in fact, bifurcating the ability of FBOs to engage in a certain amount of activity within the United States based on whether the transaction involves a "financial instrument" (and is therefore subject to the Volcker Rule) or not is confusing and raises compliance difficulties.

TOTUS SHOULD BE THE FEDERAL RESERVE'S DEFINITION OF "OUTSIDE OF THE UNITED STATES"

We believe that the revised TOTUS standard should be the standard by which transactions are judged for compliance with the requirement in Regulation K that activities be conducted "outside of the United States." It would be odd for the Federal Reserve to enforce one standard of cross-border rules for financial transactions subject to the Volcker Rule (TOTUS) pursuant to Regulation K, and another for financial transactions not subject to the

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[25] *See* 12 C.F.R. § 248.6(e).

Volcker Rule pursuant to Regulation K. Therefore, we believe that the TOTUS standard must be considered the standard for all cross-border transactions for FBOs pursuant to Regulation K.

Importantly, the Volcker Rule excludes transactions that do not involve financial instruments from its scope, presumably because such transactions are less risky. Following the logic of the Volcker Rule, which limits the ability of banking entities to engage with certain financial instruments largely due to their risky nature, FBOs should have greater (or at least equal) ability to engage in activities involving non-covered financial instruments in the United States. Thus, FBOs should be able to rely on the TOTUS standard for all trading activities that involve at least some contacts with the United States, and Regulation K should align with the TOTUS approach.

As we noted above, TOTUS itself is made part of Regulation K by its use of that provision to describe which transactions are eligible for TOTUS.[26]

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[26] *See* 12 C.F.R. § 248.6(e). In particular, the parts of TOTUS referenced in 12. C.F.R. § 248(e)(1)(ii) "The purchase or sale by the banking entity is made pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act;" and 12 C.F.R. § 248(e)(2) "A purchase or sale of financial instruments by a banking entity is made pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act for purposes of paragraph (e)(1)(ii) of this section only if: . . . ; and (ii)(A) With respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking organization requirements of section 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c) or (e)), as applicable."