Meeting Between Staff of the Federal Reserve Board and the European Banking Federation
May 9, 2018

Participants: Anna Harrington, Kevin Tran, Amy Lorenc, Flora Ahn, Greg Frischmann, and Kirin Walsh (Federal Reserve Board)

John Loatman and Jeff Siegel (BNP Paribas); John Longobardo (Credit Agricole); David Portilla (Debevoise & Plimpton LLP); John Cassidy (HSBC); Ian Montgomery (Natixis); Joerg Riegel (Société Générale); Ulrich Hannich (UBS)

Summary: Staff of the Federal Reserve Board met with representatives of the European Banking Federation (EBF) and its member banks to discuss issues related to the application of section 13 of the Bank Holding Company Act of 1956 and its implementing regulations (commonly referred to as the "Volcker Rule") to banking entities outside the United States. In particular, the EBF members and representatives encouraged the Board to modify the regulatory exemptions for certain activities by non-U.S. banking entities that occur solely outside the United States.

Attachments

European Banking Federation
<u>Proposed Revisions to the Volcker Rule's TOTUS and SOTUS Exemptions</u>

The European Banking Federation ("EBF") believes the regulations (the "Implementing Regulations") implementing section 13 of the Bank Holding Company Act ("BHC Act"), commonly referred to as the "Volcker Rule," should be revised to better accomplish the purposes of the "outside of the United States" exemptions. Our experience is that the current version of the Implementing Regulations for the "trading outside of the United States" ("TOTUS") exemption and the covered funds "solely outside of the United States" ("SOTUS") exemption is unnecessarily complex and restrictive, effectively operating as a global activity restriction and turning the statutory intent on its head.

We suggest a revised approach that would simplify the exemptions and also broaden the activity permitted thereunder, consistent with the statute. That is, as we also discussed in a comment letter to the Office of the Comptroller of the Currency ("OCC"),[1] the EBF suggests revising the Implementing Regulations consistent with the language of the statute and the agencies' expressed policy goals for the TOTUS and SOTUS exemptions. Specifically, as described below, our proposal is that activity permitted under BHC Act section 4(c)(9) for non-U.S. banking entities to be conducted outside of the United States should be exempt from the Volcker Rule in reliance on the TOTUS and SOTUS exemptions; on the other hand, activity conducted within the United States under such authority, as determined under the Federal Reserve Board's ("FRB") regulations and precedents, would not be so exempt. We have prepared this document to follow up and elaborate on our discussions with staff about the EBF's comment letter to the OCC.

Below, we briefly summarize our proposal, which is discussed in more detail in the EBF's comment letter to the OCC. Then, we explain how the FRB's Regulation K and precedents thereunder would operate to give effect to the "solely outside of the United States" language included in the statutory TOTUS and SOTUS provisions. To further illustrate our proposal, we provide examples of how the approach would apply to six different scenarios. We also clarify how our proposal would interact with the Implementing Regulations' compliance program requirements and "Super 23A" provisions.

We would be happy to meet and further discuss the issues raised in this document. If you have any questions, please do not hesitate to contact Blazej Blasikiewicz (+32-3-508-37-47; B.Blasikiewicz@ebf.eu) or EBF's outside counsel, David L. Portilla at Debevoise & Plimpton LLP (+1-212-909-6041; dlportilla@debevoise.com).

---

[1] Letter from EBF to OCC, dated Sept. 21, 2017, https://www.ebf.eu/wp-content/uploads/2017/09/EBF-OCC-RFI-Volcker-Rule-Comment-Ltr.pdf.

Table of Contents

I. The Volcker Rule Should Have Limited Extraterritorial Reach for Non-U.S. Banking Entities.

We believe the Implementing Regulations should be revised to have limited applicability outside of the United States for non-U.S. banking entities. We also think this approach is consistent with the statute's language and the FRB's historical approach to administering the BHC Act, of which the Volcker Rule is a part.

In particular, the statutory TOTUS and SOTUS exemptions[2] reference sections 4(c)(9) and 4(c)(13) of the BHC Act and, for non-U.S. banking entities, exempt from the

[2] 12 U.S.C. § 1851(d)(1). The two exemptions are as follows:

> (H) Proprietary trading conducted by a banking entity pursuant to paragraph (9) or (13) of section 1843(c) of this title, provided that the trading occurs solely outside of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or one or more States.

Volcker Rule's prohibitions activities conducted pursuant to those BHC Act sections. For non-U.S. banking organizations, section 4(c)(9) is the key limit on the extraterritorial reach of the BHC Act's section 4 nonbanking restrictions. In the mold of section 4(c)(9) and the FRB's Regulation K adopted thereunder, the Implementing Regulations should be revised to have, in their entirety, limited applicability <u>outside</u> of the United States for non-U.S. banking entities. Indeed, the agencies acknowledged in the preamble to the final rule that the purpose of the TOTUS and SOTUS exemptions is to "limit the extraterritorial application" of the Volcker Rule as it applies to non-U.S. banking entities.[3] As noted, our experience is that this intent has not been achieved. Indeed, data from EBF members, encompassing in total over 700 trading desks, indicate that the Implementing Regulations have a vast extraterritorial reach, with the current TOTUS exemption rendered ineffective. In particular, approximately 77 percent of these banks' trading desks are located outside of the United States, yet of those non-U.S. desks, over 82 percent rely on exemptions other than TOTUS. At the same time, only approximately 17 percent rely on TOTUS. An effective TOTUS exemption would result in percentages opposite to those of our survey results. Therefore, our approach is intended to give effect to the stated policy objective and the statutory language by creating congruity between the non-U.S. activities permitted to foreign banking organizations under BHC Act section 4(c)(9) and the activity covered by the TOTUS and SOTUS exemptions in BHC Act section 13. We believe this construct reflects the intent and a logical reading of section 13.

To that end, we propose the Implementing Regulations should be revised as follows:

- First, for non-U.S. banking entities, all activities permitted for "qualifying foreign banking organizations" ("<u>QFBOs</u>") to be conducted <u>outside</u> of the United States under Regulation K should be exempt from the Implementing Regulations' prohibitions under the TOTUS and SOTUS exemptions.

- Second, to the extent that Regulation K would permit a non-U.S. banking entity to engage in proprietary trading or covered fund activities <u>in the United States</u>, such activity could not be conducted in reliance on the TOTUS or SOTUS exemptions. Instead, any such activity that implicates the Volcker Rule would have to comply

---

(I) The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund by a banking entity pursuant to paragraph (9) or (13) of section 1843(c) of this title solely outside of the United States, provided that no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States.

[3] 79 Fed. Reg. 5536, 5655, 5738 (Jan. 31, 2014).

with another exclusion or exemption provided by the Volcker Rule and Implementing Regulations.

The limitation noted above would implement the "solely outside of the United States" clarifying language in the statute that explains how sections 4(c)(9) and 4(c)(13) apply to the Volcker Rule. That is, for proprietary trading activities under section 13(d)(1)(H), the statute explains that such trading must occur "solely outside of the United States." Similarly, for covered funds activities, under section 13(d)(1)(I), no ownership interest may be "offered for sale or sold to a resident of the United States" and any acquisition, retention or sponsorship must be conducted "solely outside of the United States." We believe the "solely outside of the United States" language should be read as clarifying the scope of sections 4(c)(9) and 4(c)(13) as applied to the Volcker Rule. In other words, if a non-U.S. banking entity engages in business or activities <u>in the United States</u> pursuant to and as defined under Regulation K, the TOTUS and SOTUS exemptions would <u>not</u> exempt such activity from the Volcker Rule. On the other hand, activity conducted pursuant to Regulation K from <u>outside</u> of the United States would fall within the TOTUS and SOTUS exemptions. Therefore, the limitations under the current Implementing Regulations on transactions "with or through" a U.S. entity and the involvement of the banking entity's and counterparties' U.S. personnel in the "arrangement, negotiation, or execution" of a transaction would be eliminated and replaced by our proposed framework. Further, because such activity could be conducted in reliance on the TOTUS or SOTUS exemptions and would not need to be taken into account to determine the availability of the market making or other exemptions relied upon by a non-U.S. banking entity's U.S. operations, we believe our proposal would provide a broader and more appropriate extraterritorial limit.

II. The FRB's Regulation K Precedents Provide Appropriate Limits That Would Ensure Activity Is Conducted "Solely Outside of the United States."

We believe our proposal's reference to Regulation K appropriately defines the scope of and limits to the activities exempt from the Volcker Rule's prohibitions under the TOTUS and SOTUS exemptions. Sections 4(c)(9) and 4(c)(13) are exemptions to the BHC Act's generally applicable restrictions on nonbanking activities. Specifically, these provisions authorize the FRB to exempt activities or investments of foreign banking organizations by regulation if the FRB "determines that, under the circumstances and subject to the conditions set forth in the regulation . . . the exemption would not be substantially at variance with the purposes of [the BHC Act] and would be in the public interest."[4] The FRB has implemented these provisions through Regulation K.[5] We

[4] 12 U.S.C. §§ 1843(c)(9), (c)(13).

[5] The FRB promulgated the predecessor to today's Regulation K in 1971 by amending section 225.4 of Regulation Y (12 C.F.R. § 225.4) to add paragraph (g). At the time of adoption, the regulation permitted foreign bank holding companies to "[e]ngage in direct activities of any kind outside the

believe the references to sections 4(c)(9) and 4(c)(13) in the Volcker Rule show that the Volcker Rule was intended to follow the historical extraterritorial approach of the BHC Act. As relevant to our proposal, the FRB has described section 4(c)(9), and the Regulation K provisions adopted thereunder, as exempting "among other things, all foreign activities of QFBOs from the nonbanking prohibitions of the BHC Act."[6] Therefore, it follows that the TOTUS and SOTUS exemptions should be revised to align with the scope of activities permissible under Regulation K for QFBOs, limited in a way to give effect to the "solely outside of the United States" clarifying language. Using the FRB's prior articulation, our view is that the Volcker Rule intends to exempt all "foreign activities" of foreign banking entities under the TOTUS and SOTUS exemptions, but not the "other things" (which are limited U.S.-based activities) the FRB also has permitted a QFBO to conduct in reliance on section 4(c)(9). We explain this in more detail below.

Regulation K permits a QFBO to "[e]ngage in activities of any kind outside the United States."[7] Similarly, it permits a QFBO's subsidiaries to engage in activities of any kind outside the United States. Regulation K, however, also permits a QFBO and its subsidiaries to engage <u>in the United States</u> in activities "that are incidental" to its activities and business outside the United States.[8] Further, under limited circumstances, a QFBO or its subsidiaries may engage in business in the United States beyond activities that are merely "incidental."[9]

Under Regulation K, being "engaged in activities" in the United States means "maintaining and operating an office (other than a representative office) or subsidiary in the United States."[10] Further, under the FRB's published interpretations, a company is engaged in activities in the United States if it owns, leases, maintains, operates or controls, among other kinds of offices, a sales or service outlet or "[s]imilar facility for the manufacture, distribution, purchasing, furnishing, or financing of goods or services

---

United States" (paragraph (g)(2)(i)) and "[o]wn or control voting shares of any company that is not engaged, directly or indirectly, in any activities in the United States except as shall be incidental to the international or foreign business of such company" (paragraph g(2)(iii)). These provisions are the predecessors to today's Regulation K, 12 C.F.R. §§ 211.23(f)(1) and (f)(3).

6 66 Fed. Reg. 54346, 54367 (Oct. 26, 2001).

7 12 C.F.R. § 211.23(f)(1). Under Regulation K, a QFBO must meet the requirements set out in 12 C.F.R. §§ 211.23(a), (c) or (e).

8 *See* 12 C.F.R. § 211.23(f)(2) and (f)(3).

9 12 C.F.R. § 211.23(f)(5).

10 12 C.F.R. § 211.2(g).

locally in the United States."[11] For purposes of section 4(c)(9), a foreign banking organization is not engaged in 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."[12] In other words, a QFBO may derive revenue from the United States, without being deemed to conduct activities in the United States. Thus, in plain language, the FRB's approach to determine whether activity is conducted in the United States looks at whether there is a physical U.S. presence for that activity; if no such U.S. presence exists, the activity may be conducted in reliance on Regulation K as activity that is "outside of the United States."

The FRB interpretation on permissible underwriting activities of foreign banks is particularly instructive with respect to the limits on activity in the United States conducted in reliance on section 4(c)(9) and Regulation K.[13] This interpretation involved foreign banks that were members of underwriting syndicates for securities that were to be distributed in the United States by a lead underwriter, typically a U.S. broker-dealer unaffiliated with the relevant foreign bank.[14] The U.S. offices or affiliates of the foreign banks liaised with the U.S. issuer and lead underwriter in the United States and prepared documentation in connection with the underwriting.[15] The FRB said that the U.S. offices of affiliates provided "virtually all technical support for participation in the underwriting process and benefitted from profits generated by the activity." [16] However, the underwriting obligation and risk was booked to a non-U.S. office or affiliate.[17] By booking the transaction outside of the United States, the foreign banks argued their activities could not be considered as conducted in the United States.[18] The FRB disagreed with this approach and instead determined that such arrangements amounted to an attempt to "evade regulatory restrictions . . . by using U.S. offices and affiliates to facilitate the prohibited activity."[19] This interpretation shows that there are limits on the

---

11 12 C.F.R. § 225.124(c) (referring to 12 C.F.R. § 225.4(g), which, as noted above, *see supra* note 5, was the predecessor to today's Regulation K, 12 C.F.R. § 211.23(f)).

12 *Id*.

13 12 C.F.R. § 211.605.

14 12 C.F.R. § 211.605(b)(1).

15 12 C.F.R. § 211.605(b)(2).

16 12 C.F.R. § 211.605(c)(3).

17 12 C.F.R. § 211.605(b)(3).

18 12 C.F.R. § 211.605(c)(1).

19 12 C.F.R. § 211.605(c)(4).

ability to rely on the BHC Act's extraterritorial limits, when doing so effectively would evade otherwise applicable regulatory restrictions.

We recognize and appreciate this historical limitation, and it informs our proposal that the Implementing Regulations be revised to allow a non-U.S. banking entity to rely on the TOTUS and SOTUS exemptions to conduct any activity outside of the United States that is permitted under Regulation K and the FRB's interpretations thereunder. This approach would align the TOTUS and SOTUS exemptions in the Implementing Regulations with the historical approach of the BHC Act. As we stated above, the Volcker Rule's references to sections 4(c)(9) and 4(c)(13) indicate congressional intent to incorporate the BHC Act's extraterritorial limits into the Volcker Rule. Our proposed approach adopts Regulation K's exemption from the BHC Act for any activities conducted outside the United States. Further, to give effect to the "solely outside of the United States" language in the statute, we acknowledge that Regulation K permits QFBOs to conduct a limited scope of activities in the United States, and we propose that those activities would not be permitted to be conducted in reliance on the TOTUS and SOTUS exemptions. For any such activities in the United States that are permitted under Regulation K, a QFBO must determine if the activity implicates the Volcker Rule and, if so, rely on a different exemption or exclusion.

Our proposed approach also reflects the policy objective of Regulation K's territorial limits. Indeed, the FRB frequently has emphasized that foreign banking organizations' non-U.S. activities should not fall within the purview of the BHC Act and regulations thereunder. We see no evidence that the addition of section 13 to the BHC Act was intended to change this approach. To the contrary, the language in the statutory TOTUS and SOTUS exemptions seeks to incorporate the BHC Act's and the FRB's long-standing policy of territorial limits.

In testimony supporting the enactment of sections 4(c)(9) and 4(c)(13), FRB Chairman Arthur Burns stated that the FRB did not believe "Congress intended the [BHC Act] to be applied in such a way as to impose our ideas of banking upon other countries."[20] The FRB further has noted that Regulation K "reflects the [FRB's] view that the purposes of the [BHC] Act can be achieved without undue interference with foreign banking operations in other countries that are likely to have only incidental effects in the United States."[21] Activities exempted under Regulation K are those the FRB believed to be unlikely to have "adverse consequences in the United States of the type that Congress intended to prevent through section 4 of the [BHC] Act."[22] Thus, the

[20] FRB Chairman Arthur F. Burns, Testimony Before S. Comm. on Banking and Currency (May 14, 1970).

[21] 36 Fed. Reg. 11944 (June 23, 1971).

[22] *Id*.

FRB has accepted a broad exemption for foreign banking organizations' non-U.S. activities "because there [is] no U.S. interest served by regulating such activities."[23] Non-U.S. nonbanking activities "are not the responsibility of the U.S. government or its bank supervisory agencies."[24] Despite the agencies' stated intent to implement the TOTUS and SOTUS exemptions to provide this type of extraterritorial limit and congressional intent that suggests the historical extraterritorial limits on non-U.S. activity should apply to section 13, the Implementing Regulations in practice turn 40-plus years of precedent and policy on its head and have given rise to a global activity restriction on non-U.S. banking entities. We believe this experience and result justifies the agencies revisiting the approach reflected in the Implementing Regulations.

III. Illustrative Examples of the EBF's Proposed Approach.

To illustrate how our proposed approach would work in practice, we analyze six scenarios: four under the proposed TOTUS exemption, one under the proposed SOTUS exemption and one involving a foreign excluded fund banking entity.

A. *TOTUS Exemption.*

1. Back-to-back transactions for non-U.S. wealth management business: A non-U.S. banking entity's non-U.S. wealth management business enters into over-the-counter derivatives with non-U.S. clients. At the same time, the wealth management business enters into back-to-back transactions with U.S and non-U.S. affiliates.

    - *Analysis of non-U.S.-based activity*: This activity could be conducted in reliance on the TOTUS exemption under our proposal. First, under the FRB's precedents described above, the activity of the non-U.S. wealth management business and the activity of the non-U.S. affiliates involved in the back-to-back transactions would be regarded as conducted outside of the United States and could be conducted in reliance on Regulation K. The fact that the wealth management business may enter into a back-to-back transaction with a U.S. affiliate would not make the TOTUS exemption unavailable. This is the result because, under our approach, the limitation in the current Implementing Regulations on risk-mitigating hedging transactions with U.S. offices or affiliates would be eliminated. Instead, our approach looks to where the activity is conducted, as determined under the FRB's Regulation K precedents. Thus, in this scenario, the non-U.S. affiliate could conduct these customer-facing and hedging activities under the TOTUS exemption.

[23] 62 Fed. Reg. 68424, 68438 (Dec. 31, 1997).

[24] FRB Governor Henry C. Wallich, Testimony Before H. Subcomm. on Commerce, Consumer and Monetary Affairs of Comm. on Gov. Operations (June 25, 1980) ("Wallich Testimony").

- *Analysis of U.S.-based activity*: The U.S. affiliate could not rely on the TOTUS exemption, as it would be conducting market making activity in a U.S. office. As noted above, where U.S.-based activity is present, the banking entity would need to determine whether that activity implicates the Volcker Rule and, if so, rely on a different exemption or exclusion. Here, the U.S. affiliate's activity implicates the Volcker Rule (it is engaged in principal trading activity by providing financial intermediation services to its customer, a non-U.S. affiliate) and, therefore, would require reliance on another exemption under the Volcker Rule. In this case, the appropriate exemption would be the exemption for market making-related activities.

2. <u>U.S. market making that is part of a global operation that "passes the book"</u>: A non-U.S. banking entity maintains a global market making operation that "passes the book" over a 24-hour period from its Asia-based traders, to its E.U.-based traders and then to its U.S.-based traders. The operation is structured in this way to have local personnel running the book during business hours in the major financial centers. As a result, when the book "passes" to the United States, personnel located in the United States conduct the trades. Trades may be booked to U.S. and non-U.S. banking entities by personnel in any location.

    - *Analysis of non-U.S-based activity*: Non-U.S.-based traders that book trades to a U.S. banking entity could not rely on the TOTUS exemption. A contrary result would allow the U.S. banking entity to benefit from activity that, if it were to be conducted directly in the United States, would require the U.S. banking entity to rely on the Volcker Rule's exemption for market making-related activities. Thus, in this scenario, non-U.S.-based traders would have to rely on the exemption for market making-related activities if they booked trades to a U.S. banking entity.

    - *Analysis of U.S.-based activity*: The U.S.-based traders clearly would be regarded as conducting activity within the United States and, therefore, would need to rely on the Volcker Rule's exemption for market making-related activities.

3. <u>Treasury operations of non-U.S. subsidiaries and head office</u>: The non-U.S. offices of non-U.S. banking entities, including the banking entity's European head office, serve a variety of treasury management purposes, such as currency risk management and liquidity management. These operations include, during local business hours, transactions in FX derivatives, FX spot trades and interest rate derivatives. Some trades (such as FX derivatives) are uncleared. To the extent the quotes of a U.S.-based counterparty are advantageous, the non-U.S. entities might enter into trades with that U.S.-based counterparty. Some of the trades are with internal desks, including desks operated by U.S. offices or affiliates.

- *Analysis of non-U.S.-based activity*: The result is the same as in the first scenario. Because the operations here are conducted in offices outside of the United States, if these treasury operations would require an exemption under the Volcker Rule, they could be conducted in reliance on the TOTUS exemption. The fact that the non-U.S. treasury operations may enter into trades with U.S.-based affiliated and unaffiliated counterparties would not make the TOTUS exemption unavailable because the limitation in the current Implementing Regulations on transactions "with or through" U.S. entities and the prohibition involving a counterparty's U.S.-based personnel in the "arrangement, negotiation, or execution" of a transaction are unnecessary. Instead, we look to where the activity is conducted, as determined under the FRB's Regulation K precedents.

- *Analysis of U.S.-based activity*: As in the scenarios above, trading activity of a U.S. affiliate could not be conducted in reliance on the TOTUS exemption because the activity occurs in a U.S. office. Therefore, if the U.S. affiliate's trading activity implicates the Volcker Rule, the U.S. affiliate would have to rely on a different exemption or exclusion under the Volcker Rule.

4. <u>Market making business in Europe</u>: A market making business of a European banking entity conducts a variety of client-facing businesses from its offices in Europe, including over-the-counter derivatives (cleared and uncleared) and acting as market maker in a variety of products. To source its cash positions (*e.g.*, equities), the banking entity relies on internal global repo and / or securities lending arrangements. In some cases, the banking entity may source cash instruments from or through a U.S. affiliate. The business is limited in its reach outside Europe as it is located in Europe and only operates during European business hours. Accordingly, clients are predominantly large institutional investors domiciled in Europe, including the European operations of American, Asian and other global organizations. However, some clients may be U.S.-domiciled. For certain U.S. asset classes, E.U.-based personnel seek pricing advice from U.S.-based personnel of a U.S. affiliate. In these circumstances, the U.S.-based personnel provide advice as to considerations affecting price, but the E.U.-based personnel at the European banking entity ultimately determine the price offered to clients. The U.S.-based personnel also are involved, in appropriate cases, in hedging activity related to over-the-counter derivatives entered into by the E.U.-based personnel; specifically, traders located in the United States may execute risk-mitigating hedging transactions for a U.S. affiliate for assets for which they have market expertise.

    - *Analysis of non-U.S.-based activity*: For purchases and sales where there is no involvement of the banking entity's U.S.-based personnel, the scenario would fall within our proposed TOTUS exemption. This activity would be regarded as outside of the United States and could be conducted in reliance on

Regulation K. Moreover, even in the variations of this scenario with U.S.-based personnel involvement, the E.U.-based market making activity would fall within the TOTUS exemption, as the activity is not conducted through a U.S. office and could be conducted in reliance on Regulation K.

  - The FRB has recognized that a foreign banking organization may derive revenue from the United States without engaging in a U.S. activity.[25] Thus, the fact that some clients are U.S.-domiciled or affiliates of U.S.-headquartered parents does not render this a "U.S. activity."

  - Further, the global repo and stock lending operations that may be used to source securities from a U.S. affiliate do not make the TOTUS exemption unavailable.

  - Finally, the fact that the European banking entity may trade through U.S. market infrastructures would not make the TOTUS exemption unavailable. As noted above, the current limitations with respect to transactions "with or through" U.S entities and the prohibition on involving U.S.-based personnel of clients in the "arrangement, negotiation, or execution" are not relevant under our proposal; instead the inquiry is whether the activity is conducted outside of the United States, as determined under the FRB's Regulation K precedents.

- *Analysis of U.S.-based activity*: The U.S.-based personnel who are providing pricing advisory services to an affiliate do not implicate the Volcker Rule at all, as they are not engaged in principal activity.[26] The U.S.-based hedging transactions would have to rely on the Volcker Rule's exemption for risk-mitigating hedging activity or market making-related activity, as appropriate. In addition, any repo or stock lending activity conducted from U.S. offices would rely on the exclusions from the proprietary trading definition for such activity. The analysis above of the non-U.S.-based activity and its reliance on the TOTUS exemption would not be affected by the U.S. activity in this example.

---

25 *See* supra note 11.

26 The Volcker Rule's proprietary trading prohibition applies to purchases and sales of financial instruments conducted "as principal." 12 U.S.C. § 1851(h)(4). In a similar vein, U.S.-based personnel that are engaged in back office activities, such as activities supporting the clearing and settlement of transactions, would not implicate the Volcker Rule.

B. *SOTUS Exemption.*

1. Sponsorship or investment in covered fund: A non-U.S. banking entity organizes certain funds outside of the United States, exclusively sold to non-U.S. investors. Another part of the non-U.S. banking entity invests in a covered fund of an unaffiliated third party, but does not participate in the offer or sale of such covered fund interests, nor does the banking entity serve, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading adviser to the covered fund.

   - With respect to sponsorship, whether such a scenario will remain possible will depend on the definition of "covered fund" that agencies decide upon as part of their review of the Volcker Rule. If the "covered fund" definition more closely hews to sections 3(c)(1) and (3)(c)(7) of the Investment Company Act of 1940 (*i.e.*, does not cover commodity pools not sold to U.S. persons), the sponsorship of a "covered fund" organized and offered exclusively outside of the United States will become a null set and, therefore, there would be no need to rely on the SOTUS exemption.[27]

   - With respect to investments in third-party covered funds, consistent with the current Implementing Regulations (as interpreted by Frequently Asked Question No. 13), the non-U.S. banking entity would be permitted to make this investment in reliance on the SOTUS exemption. Our approach would apply to any definition of "covered fund" that the agencies decide upon.

   - If, however, the non-U.S. banking entity were to participate in the offer or sale of covered fund interests to U.S. residents, the SOTUS exemption would not be available. Our approach recognizes that the offer or sale of covered fund interests by a non-U.S. banking entity to U.S. residents is not permitted by the plain language of BHC Act section 13(d)(1)(I).

C. *Treatment of Foreign Excluded Funds under TOTUS and SOTUS*.

1. Application of the Volcker Rule to foreign excluded funds: A non-U.S. banking entity invests for hedging and seeding purposes in 25 percent or more and / or has management control of a non-U.S. fund that is not a "covered fund." The foreign excluded fund may engage a third-party non-U.S. or U.S.-based sub-manager to manage some or all of its assets. The fund's investment strategy includes a

[27] Under the current rules, when a non-U.S. banking entity sponsors a non-U.S. commodity pool without any U.S. investor, such commodity pool is subject to the sponsorship restrictions, if the commodity pool operator of such commodity pool relies on CFTC Advisory 18-96 for relief from certain compliance requirements. Such commodity pool should be excluded from the definition of covered fund.

diversified portfolio of equities, which can include a percentage of U.S. equities, and also involves FX hedging (uncleared derivatives) with appropriate counterparties.

- Unless foreign excluded funds were in the future carved out of the definition of "banking entity" in the same way covered funds currently are,[28] the foreign excluded fund could be a banking entity itself and subject to the Volcker Rule's proprietary trading and covered funds prohibitions.

- Under our approach, the foreign excluded fund, assuming it is a banking entity, would be permitted to conduct its investment and trading activity in reliance on the TOTUS and SOTUS exemptions, as they are described above. Thus, any activities conducted by foreign excluded funds outside of the United States in reliance on Regulation K would properly be outside the scope of the Volcker Rule.

- Further, we do not believe the foreign excluded fund's interactions with U.S.-based parties and the U.S. securities markets make the TOTUS and SOTUS exemptions unavailable. The foreign excluded fund has the opportunity to hire both U.S.- and non-U.S.-based third-party sub-managers; if the exemptions restricted the fund only to hiring non-U.S.-based managers, U.S. firms would be highly disadvantaged, thus raising concerns regarding U.S. competitive equity. As for the trades involving U.S. equities, the non-U.S. banking entity and its foreign excluded fund would be conducting such activity outside of the United States, as any principal activity purchasing and selling financial instruments would be conducted out of non-U.S. offices.

- As discussed in the EBF's comment letter, the EBF believes foreign excluded funds should be carved out of the banking entity definition. However, if the agencies do not take that step, the analysis outlined here would be the result.

IV. Limits of Compliance Requirements and Super 23A.

Finally, we believe the agencies should confirm the limits of the compliance burden under the new regulations as well as the extraterritorial limits of "Super 23A."

Our approach would simplify the language of the Implementing Regulations and reduce the compliance burden on non-U.S. banking entities. For those activities a non-U.S. banking entity conducts under the TOTUS and SOTUS exemptions, the compliance burden should be limited to ensuring that those activities are conducted outside of the United States in reliance on Regulation K. In other words, such activities would not be subject to the requirements under Implementing Regulations § _.20, including Appendix

---

28 *See* Implementing Regulations §§ _.2(c)(2)(i).

A and Appendix B, or any successors to these requirements in the revised Implementing Regulations. This approach provides useful efficiencies as, in practice, non-U.S. banking entities already have systems and processes in place to monitor compliance with Regulation K as a part of their broader BHC Act compliance efforts.

As well, to mirror the extraterritorial limitations we set out here, we also seek confirmation that Super 23A would not prohibit covered transactions between a non-U.S. banking entity's non-U.S. operations and entities and a fund that the banking entity sponsors pursuant to the revised SOTUS exemption or otherwise advises or manages.[29] We think this approach also is consistent with the territorial limits of the Volcker Rule's "outside of the United States" exemptions. As the agencies well know, Super 23A broadly prohibits "covered transactions," such as financing transactions, between a banking entity that sponsors, advises or manages a covered fund or any affiliate of such banking entity and the sponsored, advised or managed covered fund and any other covered fund it controls. We ask the agencies to clarify that Super 23A does not override the extraterritorial limits set out in the Volcker Rule, as clarified in our version of the SOTUS exemption. We think this approach would be consistent with how the agencies implemented Super 23A, by excluding from its scope the acquisition of ownership interests from a covered fund in reliance on the asset management exemption (which acquisition otherwise would be a "covered transaction"). There, the agencies said that the approach "resolved an apparent conflict" in the statute and that "there is no evidence Congress intended [Super 23A] to override the other provisions of section 13."[30] We believe the same logic should be applied to the SOTUS exemption, and Super 23A should not be implemented to override the territorial limits that the "outside of the United States" provisions are intended to provide. The result would be that only covered transactions between U.S. branches, agencies and subsidiaries of a non-U.S. banking entity and any of its sponsored, advised or managed covered funds, or covered funds controlled by such covered funds, would be prohibited by Super 23A.

***

[29] *See* Implementing Regulations § _.14(a).

[30] 79 Fed. Reg. at 5746.

European Banking Federation
Illustrative Revisions to TOTUS and SOTUS Regulatory Text

Below are illustrative revisions to the regulatory text for the Volcker Rule's TOTUS and SOTUS exemptions. These revisions would reflect the European Banking Federation's proposal, as described in the September 21, 2017 comment letter submitted to the Office of the Comptroller of the Currency and subsequent discussions with, and submissions to, the staff of the Volcker Rule-implementing agencies.

I. *TOTUS*.

Implementing Regulation § _.6(e) could be revised to read as follows:

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; and

(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); or

(B) With respect to a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of any State and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements:

(1) Total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;

(2) Total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or

(3) Total net income derived from the business of the banking entity outside of the United States exceeds total net

income derived from the businesses of the banking entity in the United States;[1] and

(ii) The purchase or sale of financial instruments by such banking entity is conducted under the authority of 211.23(f)(1), (3) or (5) of the Board's Regulation K (12 CFR 211.23(f)(1), (3) or (5)), provided that any activities incidental or other than that which are incidental to the international or foreign business of such banking entity permitted to be conducted under 211.23(f)(3) or (5) in the United States are not exempt under this section from the prohibition contained in § _.3(a).

(2) A banking entity that is described in subsection (e)(1)(i)(B) above may rely on this section for activity conducted consistent with section 211.23(f)(1), (3) or (5) of the Board's Regulation K (12 CFR 211.23(f)(1), (3) or (5)), as if such provisions applied to the banking entity, provided that the same limitation on U.S. activity provided in subsection (e)(1)(ii) applies.

(3) A banking entity that conducts a purchase or sale of financial instruments in reliance on this § _.6(e) may satisfy the compliance program requirements of this part by having in place policies and procedures reasonably designed to ensure compliance with the conditions of this section, including by relying on its existing policies and procedures designed to comply with the Board's Regulation K, subpart B (12 CFR Pt. 211, subpart B) .

II. ***SOTUS***.

Implementing Regulations § _.13(b) could be revised to read as follows:

Certain permitted covered fund activities and investments outside of the United States. (1) The prohibition contained in § _.10(a) of this subpart does not apply to the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a banking entity only 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; and

(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); or

[1] Note: this language addresses non-U.S. banking entities that are not QFBOs.

(B) With respect to a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of any State and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements:

(1) Total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;

(2) Total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or

(3) Total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the businesses of the banking entity in the United States;[2] and

(ii) The banking entity conducts its covered fund activities and investments under the authority of section 211.23(f)(1), (3) or (5) of the Board's Regulation K (12 CFR 211.23(f)(1) or (3)), provided that:

(A) Any activities incidental or other than that which are incidental to the international or foreign business of such banking entity permitted to be conducted under 211.23(f)(3) or (5) in the United States are not exempt under this section from the prohibition contained in § _.10(a); and

(B) No ownership interest in the covered fund is offered for sale or sold to a resident of the United States by such banking entity.

(2) A banking entity that is described in subsection (b)(1)(i)(B) above may rely on this section for activity conducted consistent with section 211.23(f)(1), (3) or (5) of the Board's Regulation K (12 CFR 211.23(f)(1), (3) or (5)), as if such provisions applied to the banking entity, provided that the same limitation on U.S. activity provided in subsection (b)(1)(ii) apply.

(3) An ownership interest in a covered fund is offered for sale or sold to a resident of the United States by a banking entity for purposes of subsection (b)(1)(ii) if the banking entity:

---

[2] Note: this language addresses non-U.S. banking entities that are not QFBOs.

(i) Participates in the offer for sale or sale of the covered fund interest to a resident of the United States; or

(ii) Sponsors or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator, or commodity trading adviser to a covered fund, which is offered for sale or sold to a resident of the United States.

(4) A banking entity that acquires or retains any ownership interest in, or sponsors, a covered fund in reliance on this § _.13(b) may satisfy the compliance program requirements of this part by having in place policies and procedures reasonably designed to ensure compliance with the conditions of this section, including by relying on its existing policies and procedures designed to comply with the Board's Regulation K, subpart B (12 CFR Pt. 211, subpart B).

***