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Expert Analysis

Non-U.S. Banks, 'Volcker' And 'Solely Outside the United States'

By **Kathleen A. Scott**

One of the most controversial provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] is the so-called "Volcker Rule," named after Paul Volcker, a former chair of the Board of Governors of the Federal Reserve System (FRB). The Volcker Rule refers to Section 619 of Dodd-Frank. It contains prohibitions and restrictions on the ability of banking organizations and systemically significant nonbank financial companies to engage in proprietary trading or investing in or sponsoring a hedge or private equity fund. On Nov. 7, 2011, the U.S. federal banking agencies and the Securities and Exchange Commission issued a proposed rule for comment that would implement the Volcker Rule.[2] Almost 19,000 comments were received by the time the comment period closed in February 2012, although over 18,000 of them were form letters.

One of the exemptions from the Volcker restrictions is for transactions taking place "solely outside the United States." This month's column will discuss and highlight some of the comments made by non-U.S. banks with respect to this exemption in the context of the ban on proprietary trading.

Statute

Section 619 of Dodd-Frank adds a new section 13 to the Bank Holding Company Act of 1956, as amended (BHC Act), which is codified at 12 U.S.C. §1851. The general purpose of the Volcker Rule is that unless otherwise specifically provided, a "banking entity" is prohibited from engaging in proprietary trading or acquiring or retaining an equity, partnership, or other ownership interest in, or sponsor, a hedge fund or a private equity fund.

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Subject to limited exceptions, a "banking entity" subject to the rule is defined as an insured depository institution, any company that controls an insured depository institution, a company that is treated as a bank holding company under the International Banking Act of 1978 (IBA) because it is a non-U.S. bank engaged in banking activities in the United States through a U.S. branch or agency, and any affiliate or subsidiary of the foregoing.[3]

One of the exemptions from the Volcker restrictions is for transactions taking place 'solely outside the United States.'

The statutory definition of "proprietary trading" is "engaging as a principal for the trading account of the banking entity…in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate [regulators]…determine."[4]

Section 619(d) provides for several exemptions to the general ban on proprietary trading. Section 619(d)(1)(H) provides an exemption for "[p]roprietary trading conducted by a banking entity pursuant to paragraphs (9) or (13) of section 4(c) [of the BHC Act], 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 of one or more States." Sections 4(c)(9) and 4(c)(13) are the statutory bases for the regulations issued by the Federal Reserve Board regulating a non-U.S. bank's non-banking activities in the United States.[5]

Legislative History

Senate Report 111-176 on Dodd-Frank, in discussing the Volcker Rule, generally notes that "The prohibitions in section 619 therefore will reduce potential taxpayer losses at institutions protected by the federal safety net, and reduce threats to financial stability, by lowering their exposure to risk."[6] The primary authors of Section 619 are Senators Carl Levin (D-Mich.) and Jeff Merkley (D-Ore.). On July15, 2010, when debating final passage of Dodd-Frank in the Senate, Senator Merkely explained the reason for the "solely outside the United States" exemption: "Subparagraphs (H) and (I) recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law."[7]

FSOC Study

Section 619(b)(1) required the Financial Stability Oversight Council to study and make recommendations on implementing the Volcker Rule. On Jan. 18, 2010, it issued its report,[8] which notes with respect to the effect of Volcker on non-U.S. activities that:

> The Volcker Rule applies to domestic banking operations of foreign institutions. However, because of U.S. extra-territorial regulatory constraints, the statute does not restrict proprietary trading conducted by non-U.S. entities outside the United States. These entities are not eligible for discount window loans or federal depository insurance.[9]

Proposed Regulations

The proposed regulations follow the statutory definition of "proprietary trading" as "engaging as principal for the trading account of the covered banking entity in any purchase or sale of one or more covered financial positions."[10] A "covered financial position" is defined as any position, including an option, in any security, derivative or commodity futures sale contract.[11]

Proposed section __.6(d) contains the exemptions to the proprietary trading ban. With respect to the offshore activity exemption,[12] the proposed regulation sets out four conditions that must be satisfied in order for a purchase or sale to be deemed to have occurred "solely outside the United States":[13]

> (i) The covered banking entity conducting the purchase or sale is not organized under the laws of the United States or of one or more States;
> (ii) No party to the purchase or sale is a resident of the United States;
> (iii) No personnel of the covered banking entity who is directly involved in the purchase or sale is physically located in the United States; *and*
> (iv) the purchase or sale is executed wholly outside of the United States. (Emphasis added.)[14]

Regulators' Explanation

In the Supplementary Information accompanying the proposed text, the regulators explain why the Four Conditions have been added:

> [T]he proposal focuses on the extent to which material elements of the transaction occur within, or are conducted by personnel within, the United States…. The proposed rule does not evaluate solely whether the risk of the transaction or management or decision-making with respect to the transaction rests outside the United States, as such an approach would appear to permit foreign banking entities to structure transactions so as to be "outside of the United States" for risk and booking purposes while engaging in transactions within U.S. markets that are prohibited for U.S. banking entities.…
> These [Four Conditions] are intended to ensure that a transaction executed in reliance on the exemption does not involve U.S. counterparties, U.S. trading personnel, U.S. execution facilities, or risks retained in the United States. The presence of any of these factors would appear to constitute a sufficient locus of activity in the U.S. marketplace so as to preclude availability of the exemption.[15]

Comments

Many of the comments from the major non-U.S. banks, their trade associations and in some cases, their regulators, criticized the "solely outside the United States" exemption. The comments can be broken down into the following general themes.

The proposal goes beyond the plain language of the statute: The proposed regulation adds conditions not required by the statute, which applies to proprietary trading by a non-U.S. bank as principal—the trade must take place outside the United States, there is no mention of the location of counterparties, agents or exchanges in the statutory language. The statute looks to where the risk-taking activity will be, in this case, offshore by the non-U.S. bank.[16]

> It is evident from a review of the comments that the proposed regulatory provision on trading 'solely outside the United States' needs to be materially revised to avoid an overreaching extraterritorial effect. Potentially millions of dollars in compliance costs hang in the balance on how this phrase is defined.

The proposal does not take sufficient note of the purpose of the Volcker Rule: The purpose of the Volcker Rule is aimed at lessening risks taken by those institutions subject to the so-called "federal safety net"—federal deposit insurance, and being able to obtain loans from a reserve bank's discount window. Limiting the activities of non-U.S. banks outside the United States is not a result that Congress intended, and U.S. policy cannot justify it.

The FSOC itself, in its study of the Volcker Rule, specifically cites the applicability of the rule to those institutions that access the safety net. The only non-U.S. banks that can take advantage of the safety net are U.S. branches and agencies of the non-U.S. bank, and a U.S. bank owned by a non-U.S. bank. The non-U.S. bank itself cannot access that federal safety net from outside the United States.[17]

There will be unintended consequences if the proposal is adopted as proposed: If the proposal is adopted in its current form, banks estimate that the costs of compliance will be very high for those banking entities that will be subject to the rule. As a result, a non-U.S. bank would have an incentive to avoid doing transactions where there might be the slightest U.S. connection, as difficult as it might be for the bank to sever ties given the interconnections in international financial markets.[18] As a result, there could be unintended consequences such as the following:

- Parallel markets could develop—one market (a more expensive one) dealing with transactions with a U.S. connection (such as use of a U.S. clearing facility) and the other dealing with transactions with no connection to the United States.[19]
- To avoid subjecting its global affiliates to Volcker, a non-U.S. bank could close its U.S. branch or agency, and a non-U.S. bank without such an office will be reluctant to open one. Such a move would not benefit the United States and could lead to job losses in the United States financial sector.[20]
- If there are fewer international transactions, U.S. institutions could face reduced liquidity and there could be an adverse impact on the ability of U.S. investor and corporate client counterparties to transact in non-U.S. markets and to clear risk with non-U.S. counterparties.[21]

There are other ways to meet the purpose of Volcker: Some commenters proposed alternative solutions which they felt were within the statutory purpose of Volcker, yet did not have the extraterritorial reach of some of the Four Conditions. Two of the proposed solutions were:

- The exemption should be considered satisfied if both (1) the non-U.S. banking entity holds, reports, and maintains the proprietary trading positions as principal (including financial obligations and ownership) outside the United States and (2) the non-U.S. banking entity makes the investment decisions and, if it uses a U.S. agent, the non-U.S. banking entity establishes specific directives and parameters to be implemented by the U.S. agent. The financial risks and any losses resulting from proprietary trading would be borne exclusively by the non-U.S. banking entity outside the United States.[22]
- A transaction should be considered to take place solely outside the United States if the transaction is recorded by, booked into, or otherwise legally entered into by a banking entity that is not organized under U.S. federal or state law (or, in the case of non-U.S. banks operating a branch or agency office in the United States, the transaction is not recorded as an asset or liability of the U.S. branch or agency) and the transaction is not marketed from, negotiated at, entered into or closed in an office or location of the banking entity situated in the United States.[23]

The proposal is not in keeping with the prin-

ciple of international comity: Several of the commenters were concerned about the international regulatory fallout from the perceived extraterritorial overreach of the proposed rule. They noted that the proposal fails to give due regard to the home country regulator of the non-U.S. bank, is inconsistent with the concepts of international comity (one of the stated reasons for the exemption in the first place) and national treatment, and essentially substitutes the judgment of U.S. authorities for those of other regulators in their home countries.[24]

Some of the international bank regulators themselves also weighed in, often echoing many of the same issues raised by the banks and their trade associations but also raising regulator-to-regulator supervisory issues.[25] For example, the President of the European Union Council of Ministers stated that while she understood the desire to ensure a level playing field within the United States and to prevent banks from circumventing the law, it nevertheless was important that "the permitted activities of EU firms within the EU will not be subject to the regulation, and in particular that EU firms with U.S. operations not suffer from competitive disadvantages when it comes to their non-US business simply by virtue of also operating" in the United States.[26]

The Canadian regulators in particular were very concerned that the proposal could "have important adverse consequences for Canada, limiting the liquidity of Canadian markets and hence the resilience of the Canadian financial system." The regulations instead should "rely on Canadian regulators to ensure the soundness of Canadian institutions and their trading practices, consistent with the long history of co-operation and mutual respect between Canadian and U.S. regulators and the demonstrated resilience of the Canadian financial system during past periods of global financial stress."[27]

Conclusion

It is evident from a review of the comments that the proposed regulatory provision on trading "solely outside the United States" needs to be materially revised to avoid an overreaching extraterritorial effect. Potentially millions of dollars in compliance costs hang in the balance on how this phrase is defined.

The report issued by the FSOC, the membership of which includes the same regulatory agencies responsible for the proposed rule, states that extraterritorial restraints require that the law not restrict proprietary trading conducted by non-U.S. entities outside the United States. There has to be a way to promulgate the required regulation that is consistent with the purpose of Volcker without also affecting non-U.S. activities that are conducted outside the United States by non-U.S. banks. The best approach would appear to be to finalize the regulation utilizing the statutory language and eliminating the remainder of the Four Conditions. After that, the regulators can monitor closely how banks comply and make any necessary changes based on what actually happens when the rule goes into effect.

1. Pub. L. 111-203, July 21, 2010.

2. 76 Fed. Reg.68846 (Nov. 7, 2011). The Commodity Futures Trading Commission did not join in that notice and instead published its own proposed rule implementing Volcker (the text of which conformed to the proposal issued in November 2011), in the Federal Register on Feb. 14, 2012. See 77 Fed. Reg. 8332.

3. 12 U.S.C. §1851(h)(1).

4. 12 U.S.C. §1851(h)(4).

5. See 12 C.F.R. Part 211, Subpart B.

6. Senate Report 111-176, April 30, 210, p.8.

7. 156 Cong. Rec. 5897, July 15, 2010. Paragraph (I) deals with the offshore exemption to the prohibition on investing in or sponsoring private equity funds.

8. Financial Stability Oversight Council, "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships With Hedge Funds & Private Equity Funds," (FSOC Study) which can be accessed at http://www.treasury.gov/initiatives/fsoc/Pages/default.aspx.

9. FSOC Study, p. 46.

10. Proposed §—.3(b)(1).

11. Proposed §—.3(b)(3).

12. Proposed §—.6(d)(1).

13. Proposed §—.6(d)(3).

14. The proposed regulation also sets out the qualifications for when a purchase or sale shall be deemed to be conducted pursuant to §4(c)(9) or (13) of the BHC Act by an entity that is a non-U.S. banking organization. See Proposed §—.6(d)(2).

15. 76 Fed. Reg. 68881.

16. See, for example, Feb. 13, 2012, Comment Letter from the Institute of International Bankers (IIB Comment); Feb. 13, 2012, Comment Letter from Allen & Overy on behalf of six major Canadian banks ("A&O Comment"); Feb. 7, 2012, Comment Letter from UBS ("UBS Comment").

17. See, for example, IIB Comment, A&O Comment; Feb. 7, 2012, Comment Letter from Cadwalader, Wickersham & Taft ("CWT Comment") on behalf of certain banks in Singapore.

18. See, for example, Comment Letter from the International Centre for Financial Regulation, London ("ICFR Comment").

19. See, for example, A&O Comment, UBS Comment.

20. See, for example, IIB Comment, Feb. 8, 2012, Comment Letter from The Association of Banks in Malaysia ("Malaysia Banks Comment").

21. See, for example, Feb. 13, 2012, Comment Letter from the Australian Bankers Association, Inc..

22. See, for example, IIB Comment.

23. See, for example, CWT Comment, Malaysia Banks Comment.

24. See, for example, IIB Comment, UBS Comment, CWT Comment.

25. See, for example, Feb. 8, 2012, letter to FRB Chairman Ben S. Bernanke from Adair Turner, Chairman, UK Financial Services Authority; Feb. 14, 2012, Comment Letter from the Reserve Bank of Australia; Feb. 10, 2012, Comment Letter from the Deutsche Bundesbank and the Bundesanstalt fur Finanzdienstleistungsaufsicht.

26. Feb. 21, 2012, Letter to Ben S. Bernanke from Margrethe Vestager, President of the EU Council of Ministers.

27. Feb. 13, 2012, Comment Letter from Mark Carney, Governor, Bank of Canada.