

FEDERAL RESERVE BANK  
OF NEW YORK

Circular No. 7109  
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INTERPRETATION OF REGULATION K

To All Member Banks, and Others Concerned,  
in the Second Federal Reserve District:

Printed below is an excerpt from the *Federal Register* of March 5, containing the text of an interpretation of Regulation K, issued February 22 by the Board of Governors of the Federal Reserve System. The interpretation provides that foreign subsidiaries of Edge Act corporations may engage in international joint account arbitrage as an incident to their dealings in securities abroad.

Additional copies of this circular will be furnished upon request.

Alfred Hayes,  
President.

Title 12—Banks and Banking  
CHAPTER II—FEDERAL RESERVE SYSTEM  
SUBCHAPTER A—BOARD OF GOVERNORS OF  
THE FEDERAL RESERVE SYSTEM  
[Reg. K]  
PART 211—CORPORATIONS ENGAGED IN  
FOREIGN BANKING AND FINANCING  
UNDER THE FEDERAL RESERVE ACT  
Dealing in Securities

The Board of Governors has ruled that a foreign subsidiary of an Edge Act corporation that engages in the business of buying and selling securities outside the United States may participate, as an incident to that business, in international arbitrage under a joint arrangement with a member firm of the New York Stock Exchange, in accordance with Rule 437 of the exchange. International arbitrage involves the business of buying and selling securities in one market with the intent of reversing such transactions in a market in a country different from that in which the original transaction has taken place, in order to profit from price differences between such markets, and which business is not casual, but contains the element of continuity.

The Board's ruling relates to the Edge Act (section 25(a) of the Federal Reserve Act) and the Board's Regulation K. It sets forth special restrictions on the foreign subsidiary's participation intended to limit the activity to bona fide arbitrage

incidental to a foreign securities business, as well as special reporting requirements to monitor activities undertaken pursuant to such ruling. To publish its ruling, the Board has issued the following interpretation:

§ 211.109 International joint account arbitrage incidental to securities business abroad.

(a) A question has been raised with the Board as to whether a foreign subsidiary of a corporation organized under section 25(a) of the Federal Reserve Act (an Edge corporation) may participate with a member firm of the New York Stock Exchange in the operation of an international arbitrage joint account of the kind authorized by rule 437 of the New York Stock Exchange with permission of the Exchange. The Edge corporation's investment in the foreign subsidiary was made subject to the Board's standard condition that the subsidiary should not engage in any activities that would not be permissible if it were a corporation organized under section 25(a) not "engaged in banking" within the meaning of § 211.2(d) of this part (regulation K). For the reasons hereinafter stated, the Board believes that, under appropriate conditions, such participation in an international arbitrage account is not prohibited by either section 25(a) of the Federal Reserve Act or regulation K.

(b) The foreign subsidiary on whose behalf the inquiry was made was a foreign bank that is engaged in the business of dealing in securities outside the United States, including securities that are issued by corporations chartered in the United States and are listed on the New York Stock Exchange. The international arbitrage joint account will be operated in accordance with the rules of the New York Stock Exchange. The foreign bank would post to the joint account transactions executed by it in foreign markets in securities listed on the Exchange. Purchases and sales in foreign markets would be made primarily from or to foreign-owned financial institutions dealing in securities. The member firm of the Exchange would execute orders on the Exchange reversing those transactions on the same business day, thereby eliminating long or short positions in the joint account before the end of the New York trading day. The foreign bank and the member firm would share equally in profits and losses on the operations of the account.

(c) The question posed involves an interpretation of paragraph 10 of section 25(a) and § 211.5(b) of regulation K. Paragraph 10 of section 25(a) prohibits an Edge corporation from carrying on any part of its business in the United States except such as, in the Board's judgment, shall be incidental to its international or foreign business. (With

(Over)

regard to the permissible operations of foreign subsidiaries of Edge corporations, the effect of paragraph 10, under the Board's standard condition mentioned above, is to duplicate the prohibition contained in paragraph 8 of section 25(a) against investment by an Edge corporation in any corporation transacting any business in the United States except such as, in the Board's judgment, may be incidental to its international or foreign business.) Section 211.5(b) of regulation K prohibits an Edge corporation, with certain exceptions not material to this ruling, from engaging in the business of selling or distributing securities in the United States or underwriting any portion thereof so sold or distributed.

(d) International arbitrage involves engaging in the business of buying or selling securities in one market with the intent of reversing such transactions in a market in a country different from that in which the original transaction has taken place, in order to profit from price differences between such markets. In the Board's judgment, the participation by

foreign subsidiary of an Edge corporation in an international arbitrage joint account, as described above, with a member firm of the New York Stock Exchange would not place that foreign subsidiary in the business of selling or distributing securities in the United States, or involve it in carrying on any part of its business in the United States except such as may be incidental to its international or foreign business, if the account is operated subject to the following restrictions: (1) Transactions in the United States shall be confined to those that reverse prior transactions initiated in foreign markets, (2) purchases and sales of securities outside the United States shall be made only from or to foreign residents not controlled by any U.S. company, (3) transactions shall be confined to bona fide arbitrage as defined for purposes of rule 437 of the New York Stock Exchange, (4) the joint account shall be regularly settled between the participants at no greater than quarterly intervals, and (5) in no event will orders be placed for the joint account in securities being underwritten

by the foreign subsidiary. Under such circumstances, the Board is of the opinion that a foreign subsidiary of an Edge corporation may engage in international joint account arbitrage as an incident to its dealings in securities outside the United States consistently with section 25(a) and regulation K.

(e) Full information concerning the volume and the nature of the transactions in such an account and enabling assessment of compliance with the foregoing restrictions shall be available and will be reviewed during examinations of an Edge corporation whose foreign subsidiary participates in an international arbitrage joint account. Such information shall be retained in the Edge corporation's records for at least 3 years after such transactions are executed.

[Interprets and applies 12 U.S.C. 615]

By order of the Board of Governors of the Federal Reserve System, February 22, 1973.