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INSTITUTE OF INTERNATIONAL BANKERS

ANNUAL INSTITUTE SEMINAR ON RISK MANAGEMENT AND REGULATORY EXAMINATION/COMPLIANCE ISSUES AFFECTING INTERNATIONAL BANKS

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Emerging Trends and Key Developments in the Regulation and Supervision of Branches and Agencies of International Banks and in the Regulation of International Banks Themselves as Bank Holding Companies and Financial Holding Companies

Operational Risk Management and Related Issues from a Legal and Regulatory Perspective

New York
October 20, 2010

ROBERT L. TORTORIELLO
CLEARY GOTTLIEB STEEN & HAMILTON LLP
Tel. No.: 212-225-2390
E-mail: rtortoriello@cgsh.com

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from a Legal and Regulatory Perspective[1]

I. Introduction

Operational risk management remains an increasingly critical ongoing regulatory and supervisory focus for international banks.

A. Nature of "Operational Risk"[2]

1. "Operational Risk" has generally been defined as the risk of unexpected, direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events. The definition includes Legal Risk (i.e., the risk of loss resulting from failure to comply with laws, ethical standards and contractual obligations). It also includes the exposure to litigation from an institution's activities. While the definition does not necessarily include Strategic or Reputational Risks, these Risks are typically significant factors in risk management programs and are treated within Operational Risk for purposes of this Outline.

a. Operational Risk losses are characterized by event factors associated with (i) internal fraud (an intentional act intended to defraud, misappropriate property or circumvent the law or

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1 This Outline is intended to highlight certain selected legal/regulatory compliance and related developments over the past several months with respect to the regulation and supervision of branches and subsidiaries of international banks. (For purposes of this Outline, the term "U.S. branch" of an international bank encompasses U.S. agencies as well.)

This Outline is intended to be current as of October 12, 2010, and focuses in general on the most recent precedents which affect the evaluation and monitoring of key issues respecting Operational Risk from a capital markets perspective.

2 For recent regulatory and other background and discussion of operational and related risks, see, e.g., Tortoriello & Glotzer, Guide to Bank Underwriting, Dealing and Brokerage Activities (West LegalWorks, 14th ed., 2009) (the "Bank Activities Guide") at Part II.A.

bank policy); (ii) external fraud; (iii) employment practices; (iv) clients, products and business practices (unintentional or negligent failure to meet a professional obligation (including fiduciary and suitability requirements)); (v) damage to physical assets; (vi) business disruption and system failures; or (vii) failed execution, delivery and process management.

b. Operational Risk is a broader concept than "operations" or back office risk. It encompasses risk inherent in business activities across a financial institution -- including (i) corporate finance, (ii) trading and sales, (iii) retail banking, (iv) commercial banking, (v) payment and settlement, (vi) agency services, (vii) asset management, and (viii) retail brokerage. Regulators have noted diversification of banks' lines of business, over-the-counter derivative and other trading activities, outsourcing arrangements, and e-commerce as sources of Operational Risk.

The key fear is that of the "fat tail" result: occurrence of an event is rare, but the effects disproportionately damaging.

c. Reputational Risk is receiving increasing attention, and compliance failures are perceived as the biggest source of reputational risk.

d. Ultimate implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203 (2010) ("Dodd-Frank") -- including in particular the restrictions in Dodd-Frank § 619 (the so-called "Volcker Rule") on proprietary trading and on sponsorship of (and investment in) private equity funds and hedge funds (collectively, "hedge funds") -- will require even more attention to Operational Risk issues and concerns.

2. An "Operational Risk event" can involve (a) direct charges to income and write-downs, (b) external costs incurred as a consequence of the event, (c) specific provisions required to be taken, (d) pending (projected) and timing losses, and (e) opportunity costs/lost revenue.

3. From a "Pillar 1" Basel capital perspective, Operational Risk will need to receive the same rigor of analysis, governance and risk management processes as are employed with respect to Credit and Market Risks. The "Pillar 2" principle of supervisory review also appears critically relevant to Operational Risk management.

B. Scope of U.S. Regulation and Supervision at U.S. Branches and Subsidiaries of International Banks

1. Enhanced Risk Management and Oversight

In 2008, the Federal Reserve Board (the "FRB") (a) issued enhanced guidance that refines and clarifies its programs for the consolidated supervision of U.S. bank holding companies ("BHCs") and the combined U.S. operations of foreign banking organizations ("FBOs"), and (b) clarified supervisory expectations with respect to firmwide compliance risk management.

a. Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles (FRB Supervisory Release, 08-8/CA 08-11 (October 16, 2008)).

(i) Larger, more complex banking organizations require a firmwide approach to Compliance Risk management and oversight that includes a corporate compliance function for both risk management and oversight. For an FBO, either compliance oversight of U.S. activities may be conducted in a manner consistent with the FBO's broader Compliance Risk management framework, or a separate function may be established specifically to provide compliance oversight of the FBO's U.S. operations.

(ii) FRB supervisory findings consistently reinforce the need for compliance staff to be independent of the business lines for which they have compliance responsibilities.

(a) If an FBO chooses to implement an organizational structure in which compliance staff within a business line have a reporting line into the management of the business, compliance staff should <u>also</u> have a reporting line to the corporate function with compliance responsibilities.

(b) In addition, an FBO that chooses to implement a dual reporting structure should ensure that (i) the corporate compliance function plays a key role in determining how compliance matters are handled, and in personnel decisions and actions (including remuneration) affecting business line compliance and local compliance staff (particularly senior compliance staff); (ii) compensation and incentive programs are carefully structured to avoid undermining the independence of compliance staff (<u>i.e.</u> <u>not</u> on the basis of the financial performance of the business line); and (iii) appropriate controls and enhanced corporate oversight identify and address issues that may arise from conflicts of interest affecting compliance staff within the business lines.

b. <u>Consolidated Supervision of [BHCs] and the Combined U.S. Operations of [FBOs]</u> (FRB Supervisory Release 08-9/CA 08-12 (October 16, 2008)) specifies the principal areas of focus for consolidated supervision, highlights the supervisory attention that should be paid to risk management systems and internal controls, and reiterates the importance of FRB coordination with (and reliance on) the work of the relevant primary supervisors and functional regulators. Primary areas of focus for an FBO will include:

(i) Key corporate governance functions, including internal audit.

(ii) Risk management and internal control functions for primary risks of the FBO’s combined U.S. operations.

(iii) Activities in key financial markets in which the FBO plays a significant role, as well as related risk management and internal controls.

(iv) Areas of emerging interest with potential financial market consequences.

(v) Financial strength of the FBO's combined U.S. operations.

(vi) Risk management and financial condition of significant non-bank subsidiaries.

(vii) Funding and liquidity of the FBO's U.S. operations.

2. "Home Country" v. "Host Country" Supervisory Focus/Licensing Issues[3]

a. Examination issues have arisen as to the appropriate role of a "host country" supervisor (like the FRB) with respect to the global operations of an international bank from the perspective of Operational Risk management.

These issues have become accentuated as host country supervisors focus examination questions and resources "horizontally" across markets and geographies, and evaluate an FBO's U.S. subsidiaries (as well as its branches) more broadly, including both subsidiaries which are, and are not, subject to "functional regulation" by other regulators.

b. The FRB has recognized that, as a "host country" supervisor, it has full access to information concerning an international bank's U.S. operations, but does not have the same level of access to information on the international bank's consolidated operations and risk management systems as the home country supervisors.

(i) The FRB has indicated that it expects to focus particular attention in its examination of U.S. offices

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[3] See generally Good Practice Principles on Supervisory Colleges (Basel Committee on Banking Supervision, October 2010) (good practice principles applicable to "supervisory colleges" (multilateral working groups of supervisors that are formed for the collective purpose of enhancing effective consolidated supervision of an international banking group on an ongoing basis), including with respect to information sharing, communication channels, collaborative work and crisis management).

and affiliates of an international bank on the bank's consolidated financial condition, capital adequacy and general ability to support its U.S. operations.

(ii) The FRB has also stated that it needs to have a sufficient understanding of an international bank's global risk management and internal control systems in order to evaluate how those systems are applied with respect to the oversight and control of the bank's U.S. operations, and that, in many cases, the centralized nature of an international bank's management of certain business lines or control functions may necessitate discussions with corporate management at the bank headquarters level.

c. In light of the financial crisis and market turbulence of 2007-2009, capital issues, considered on a global, multi-regulator basis, have become increasingly important (derived, in part, from the requirement that an FBO which is a "financial holding company" (an "FHC") under the Gramm-Leach-Bliley Act (the "GLBA") satisfy "well-capitalized" standards.

(i) Financial institutions are expected to be prepared to demonstrate the effectiveness of internal capital adequacy assessments and strategies, the ability to monitor and ensure compliance with regulatory capital ratios, and the effectiveness of a process for assessing overall capital adequacy in relation to risk, including (A) board and senior management oversight; (B) policies and procedures to identify, manage and report risks, relate capital to the level of risk, set capital adequacy goals with respect to risk, and incorporate controls and audits to insure the integrity of the risk management process; (C) comprehensive risk assessment; (D) a system for monitoring and reporting risk exposures; and (E) an internal control review structure.

(ii) The role of a leverage ratio in capital planning has received renewed international attention. [4]

d. Potential areas of focus in implementing Operational Risk standards for an international banking operation involve (i) home-host supervisory cooperation, and (ii) the bifurcated application of Basel capital standards the United States and the special issues it creates for cross-border banking.

(i) Banking organizations have expressed concerns about the prospect of each national supervisor asking different questions about Basel implementation with respect to Operational Risk, demanding different data, applying the rules differently, or taking other actions that increase cost or are inconsistent with the principle of consolidated supervision. It does not matter to a host supervisor that a consolidated entity has sufficient capital if there is no assurance that, in a period of stress, capital will be available to the legal-entity subsidiary in the host country. Thus, the combination of global banking and sovereign states has, for some time, produced "tensions" that are exacerbated by Basel capital requirements for Operational Risk.

(ii) On the one hand, Basel allows both the consolidated and the individual legal entities to benefit from the risk reduction associated with group-wide diversification. However, host countries charged with ensuring the strength of the legal entities operating in their jurisdictions will not be inclined to recognize an allocation of group-wide diversification benefits, since capital among legal entities is not freely transferable (especially in times of stress). Thus, the sum of individual legal-entity capital requirements may be greater than consolidated-entity requirements.

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[4] See, e.g., Financial Markets Regulation - Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and Across System (General Accountability Office ("GAO"), July 2009).

(iii) For international banks, the additional fear and risk are that if U.S. regulators are not satisfied with the way that the bank's U.S. branches address Operational Risk and related issues, an unsatisfactory examination rating could adversely affect the bank's status as an FHC.

e. Key principles of facilitating effective host/home country supervisory coordination in the context of an FBO's U.S. operations include:

(i) <u>Transparency</u> -- the importance of good information flows to both sets of regulators; this will become particularly important as the dialog continues to develop on Operational Risk capital allocations.

(ii) <u>Coordination</u> -- not always easy for a host country manager to effect (given different time zones, reporting lines, responsibilities, etc.) but important so that the supervisory roles and responsibilities of each regulator are clear, and directions, requirements, mandates, etc. do not conflict.

(iii) <u>Pro-Active Problem Resolution</u> -- an increasingly critical step in terms of regulatory relations is staying ahead of the curve and identifying (and anticipating) areas with a greater likelihood of risk; having a reputation of being proactive in this regard can help an international bank retain (and reinforce) credibility with, and the respect of, both home and host regulators.

(iv) <u>Commitment of Resources</u> -- both in terms of senior management attention to host/home supervisory issues and in terms of support for the compliance/legal/audit function.

f. Integration by an FBO of its direct operations (whether U.S. branches or "home office") with its subsidiaries can raise licensing issues. For example, the New York Banking Department (the "<u>NYBD</u>") has advised informally that a U.S. broker-dealer subsidiary of an FBO need <u>not</u> license itself as a "representative office" under Supervisory Procedure FB2 (which requires licensing for "affiliate of [an FBO] that engages in representational functions (including, but not limited to, soliciting business, marketing services or acting as liaison with customers other than as an accommodation to customers of such affiliate) on behalf of the [FBO] in connection with its banking activities") if the broker-dealer markets certificates of deposit of the New York branch of the FBO to high net worth clients of the broker-dealer. The NYBD placed weight on the facts that broker-dealer (i) was licensed and regulated by the Securities and Exchange Commission (the "SEC"), (ii) was engaged in significant and ongoing business unrelated to the FBO's New York branch, and (iii) would be offering the certificates of deposit as an accommodation to its existing customers.

However, the NYBD did not base its conclusion on the broader propositions that (i) the NYBD's licensing rules only apply when a representative is soliciting business for a non-New York office of an FBO; (ii) licensing should not be required if an affiliate's office is in contiguous or ancillary space to the FBO's New York branch; or (iii) a broker-dealer should be viewed as an agent akin to a service provider, which should not require separate licensing because such an agent would be subject to the NYBD's plenary supervision authority over the FBO's New York branch.

II. Regulatory and Supervisory Focus on Operational Risk: Capital Markets Perspective

A. General Approach[5]

1. Management of Legal, Compliance, Strategic and Reputational Risks is a critical component of an Operational Risk control framework. Regulators expect that banking institutions will be vigilant and proactive in identifying, assessing, reporting, managing and monitoring Operational Risks.

2. There is a key relationship between risks and controls. Corporate reporting systems, documentation of policies and procedures, and training and advising front, middle and back office personnel on risk management requirements is a critical component of satisfying supervisory and regulatory objectives.

3. Corporate reporting systems, documenting appropriate policies and procedures, and training and advising front, middle and back office personnel on risk management requirements will continue to be critical components of satisfying supervisory and regulatory objectives and concerns. As a starting point, a financial institution must implement:

   a. A "tone at the top" which recognizes the importance of governing board and senior management oversight of the risk management function.

   b. A formal policy to identify, measure, assess, monitor, test and address tolerance for Legal, Operational, Compliance and Reputational Risks, including regular evaluations of risk tolerance by senior management and procedures for escalating risk concerns to appropriate levels of senior management.

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5 See, e.g., Guidelines on the Management of Operational Risks in Market-Related Activities (CEBS, October 12, 2010); Global Emerging Risks Survey: Steering the Course, Seizing the Opportunity (August 2010); Guidelines on Operational Risk Mitigation Techniques (CEBS, December 22, 2009); Compendium of Supplementary Guidelines on Implementation Issues of Operational Risk (CEBS, September 2009).

c. Consistency in risk definitions, policies, measurement, reporting, accountability and audit.

d. Written compliance programs relating to federal and state laws, regulations and supervisory requirements (as applicable, laws and regulations with respect to banking, securities, commodities, real estate, insurance, etc.).

e. Policies and procedures for satisfying applicable securities law requirements in terms of assuring adequate public disclosure of applicable risks.

f. Robust internal audit and risk reporting processes which focus on independence, planning, risk assessment, generation of alerts, exception tracking and resolution.

g. An adequate assessment of Operational Risk as part of an individual business unit's performance evaluation, and proactive response to indicia of fraud, suspicious activities or other violations of law or regulation, or of firm policies and procedures.

4. More generally, the role of legal and compliance personnel in addressing Operational and Reputational Risk concerns in an integrated financial institution has been evolving. The trend has shifted from a compliance model focused primarily on adherence to existing laws and regulations to one that targets a more complete involvement in <u>enterprise-wide risk management</u>, <u>creation of firm-wide compliance values</u>, <u>evaluation of firm-wide business practices</u>, and <u>construction of firm-specific "best practice" models</u>.

5. Among the key areas focused on to build a "culture of compliance" (and, thus, to reduce Operational and Reputational Risk) are:

a. Policies to identify, measure, assess, monitor, test and minimize Compliance/Legal/Reputational Risk, backed by a <u>well-resourced</u>, <u>independent</u> compliance staff.

b. Standards and procedures to assure compliance with "best" operational, ethical and business practices, and implementation of effective codes of conduct.

c. Attention to all of the many different sources of risk management guidance and statements of risk management concerns (including regulatory orders, staff opinions, speeches and presentations, publicly-available correspondence, etc.).

d. Cooperation with regulators (recognizing the increasing globalization of regulatory focus, communication, coordination and enforcement).

e. Close integration of the governance, risk management, remediation, reporting and compliance functions.

f. The importance of the manner in which a financial institution identifies and responds to "red flags" given the nature of its business, and the nature and scope of the institution's cooperation with regulatory/administrative inquiries.

B. Bank Trading Activities[6]

1. Bank trading activities have spurred regulators to develop a supervisory approach intended to achieve a more effective risk-based examination process focused on (a) internal environment ("tone"); (b) setting of objectives; (c) identifying and measuring internal and external events that could affect achievement procedures and controls; (g) identification, capture and communication of relevant information; and (h) monitoring of the risk management process.

2. The turmoil in credit markets has spotlighted the linkages among risk exposures previously believed to be somewhat separate and distinct (i.e., market risk, credit risk, funding risk, liquidity risk and basis risk). It has also demonstrated the importance of (a) analyzing risk exposures on a firm-wide basis and implementing holistic risk management systems, including contingency funding plans; (b) stress-testing and reviewing the assumptions underlying models and

6 See generally Amended and Restated Money Market Trading Practice Guidelines (Securities Industry and Financial Markets Association, 2010); The Prudential Regime for Trading Activities: A Fundamental Review (Financial Services Authority, August 2010); High Level Principles of Risk Management (CEBS, February 16, 2010); Risk Management Lessons from the Global Banking Crisis of 2008 (Senior Supervisory Group, October 21, 2009); Deloitte 2009 Global Risk Management Survey: Risk Management in the Spotlight; Guidelines for Foreign Exchange Trading Activities (Federal Reserve Bank of New York, May 2008).

valuation methodologies (particularly those based on limited historical data); and (c) acknowledging the risks associated with off-balance sheet entities and contingent liquidity commitments.

3. Market supervisors have recognized several areas in need of enhanced regulatory focus in light of recent events, including (a) strengthening incentives for prudential oversight of capital, liquidity and risk management processes; (b) increasing transparency through enhanced disclosure requirements, particularly with respect to valuation metrics and securitization markets; (c) strengthening regulators' responsiveness to excessive risk concentrations through improved internal and cross-border information exchanges and a continued emphasis on policy development; and (d) establishing robust policy frameworks for handling financial market stresses, including through the provision of continued central bank liquidity support.

4. There has been a general recognition of the need to develop new strategies to combat fraudulent activities, strengthen internal supervisory methods and ensure management involvement in risk monitoring. These strategies include:

   a. Heightened scrutiny of (i) trading limit breaches; (ii) unrealized profit-and-loss ("P&L") on unsettled transactions; (iii) unusual patterns of cancellations and corrections; (iv) transactions in which confirmation and settlement do not occur on a timely basis; (v) reports of aged unresolved reconciling items and aged outstanding confirmations; (vi) P&L reports that exceed an expected amount; (vii) details underlying a trader's value-at-risk; (viii) repeated requests by a trader to relax position or P&L limits or other internal controls; (ix) trading in products outside of a trader's expertise; (x) unusual differences between a trader's account positions and account activity; and (xi) a pattern of aged fails to deliver.

   b. Documented, effective allocation of supervisory roles and responsibilities.

   c. Regular reconciliation of intercompany transactions and implementation of controls for affiliated transactions.

d. Ensuring that mid- and back-office personnel have sufficient internal clout to perform their responsibilities adequately and effectively convey the importance of a "compliance culture."

5. In addition, there has been an increasing focus on the integration of ethics and compliance programs. The ethics elements of such programs are intended to reinforce compliance elements and vice versa. Successful programs reflect an institution's commitment to both integrity/honesty and legal compliance.

6. Loan trading activities can raise issues under U.S. securities laws.

a. The weight of judicial precedent is overwhelmingly in favor of the proposition that loan notes are not "securities" for purposes of federal law and that sale of loan notes to banks and non-banks is a permissible banking function.

b. However, a number of commenters continue to warn that it is possible that the combination of market developments and a heightened sensitivity to issues of trading in non-security financial instruments -— whether loans, loan participations or credit derivatives -— could lead to the conclusion that loan notes or participations have become "securities", particularly in the context of secondary market "trading".

(i) The issue is still a live one because of the ongoing evolution of the loan note market in terms of volumes, document standardization and the expanding universe of purchasers.

(ii) Moreover, the market continues to put pressure on the distinction between loan notes and securities in the manner in which the instruments (both form and terms) and transactions are structured.

(iii) In addition, the ambiguity raised in Congressional colloquies with respect to the helpful Volcker Rule provision that explicitly exempts loan sales and loan securitizations from its restrictions on proprietary trading could require a continuing focus on the manner in which loan sale transactions are conducted. The colloquy suggests that loan products could be covered by the Volcker Rule if they become financial instruments traded to capture changes in market value. 156 Cong. Reg. 55895 (daily ed. July 15, 2010).

(iv) The Interagency/Joint Release in respect of the Shared National Credits Program, dated September 2010, underscores potential risks. Over the past ten years, lenders not affiliated with banks (such as brokerage firms, mutual funds, insurance companies and hedge funds) have taken on larger positions in the syndicated loan market. These non-bank entities have increased their share to more than 21% of total commitments, compared to 2% in 1996.

The quality of holdings also varied among entity types, with classified credits (special mention, substandard, doubtful and loss) amounting to 8% of total commitments at U.S. banks compared with 30% at non-banks. Non-bank holdings of classified commitments increased significantly, rising from 21% of all classified credit commitments in 2001 to 53% in 2010.

III. Other Key Current Legal and Regulatory Issues[7]

A. Focus on identification and resolution of conflicts of interest that arise (1) between the financial institution and its customers, (2) among the financial institution's customers, and (3) among different business units of the same financial institution.

1. Conflicts of interest which arise from multiple relationships with a customer (e.g., acting as an underwriter and as an adviser to the issuer, acting as market-maker/lender/derivatives counterparty, acting as adviser on M&A transactions coupled with the issuance of fairness opinions, holding positions in debt and equity securities, having a director representative on a client's board, etc.) may require special attention so that the potentially increased risk of equitable subordination, incurring fiduciary obligations, and additional restrictions on information-sharing can be addressed.

2. Conflicts of interest may be addressed in any number of ways, including (a) determination at the business line level not to proceed in a particular conflict situation; (b) use of structural mitigation tools (e.g., information barriers, restricted/watch lists, training and surveillance); (c) elevation of issues for senior management resolution and mitigation; and (d) procedures for disclosure/consent/waiver.

3. Dodd-Frank includes 1934 Act § 27B to require the SEC to implement rules that will prohibit an underwriter, placement agent, initial purchaser or sponsor of an asset-backed security from engaging in any transactions (other than in the context of hedging activities to mitigate the risk of underwriting and market-making activities) that would involve a conflict of interest with respect to any investor in a

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[7] This Part III is not intended to set out an exhaustive list of regulatory/supervisory requirements, nor of all -- or even most -- laws, rules, regulations and other legal requirements applicable to the U.S. operations of FBOs. Rather, it is intended to identify certain matters in the context of wholesale/institutional business that have been the subject of recent regulatory concerns.

Moreover, this Outline does not address front/back office business line-related risk management processes and procedures, lending/investment issues, capital-related issues, derivatives/foreign exchange transactional issues, or similar areas that would not primarily represent a legal/compliance responsibility.

transaction arising out of such activity. (The prohibition becomes effective upon implementation of rules by the SEC by April 2011.)

4. Financial Industry Regulatory Authority (FINRA) Regulatory Notice 10-22 (April 2010) reminds broker-dealers of their duty to conduct reasonable investigations when recommending private placement offerings to their clients.

   a. Inherent in the recommendation of a security by a broker-dealer is a representation that a "reasonable investigation" has been made and that the recommendation rests on the conclusions based on such investigation.

   b. The scope of the investigation required will be affected by the broker-dealer's (i) affiliation with the issuer, which raises potential conflict of interest issues; (ii) preparation of the private placement memorandum; (iii) awareness of any "red flags" on which the broker-dealer may be obligated to conduct an independent investigation; and (iv) reliance on counsel and other experts.

   c. The Notice includes a survey of industry practices for investigations which should help ensure that intermediaries meet their reasonable investigation obligations.

B. Satisfaction of all legal and supervisory requirements applicable to the generation of deposits and other liabilities including (1) limitations in the International Banking Act on retail deposit solicitation applicable to uninsured U.S. branches of non-U.S. banks (currently $250,000 minimum, subject to designated exceptions), (2) conduct of liquidity stress testing, including in the context of the proportion and amount of exposures to a U.S. branch by non-U.S. branches and affiliates, and (3) careful monitoring of the manner, disclosure and focus of deposit and note sales to U.S. and non-U.S. investors/depositors.[8]

[8] See 12 U.S.C. § 3104(d), 12 C.F.R. §§ 28.16, 347.206 et seq.; Interagency Policy Statement on Funding and Liquidity Risk Management, 75 Fed. Reg. 3656 (March 22, 2010); FRB Advisory on Interest Rate Risk Management (January 6, 2010).

See also, e.g., Zions Direct, FINRA Press Release, August 25, 2010 (conflicts of interest in deposit program); New York Stock Exchange ("NYSE") Information

fn cont.

C. Evaluation of issues with respect to the identification and treatment of material non-public information in the context of loan, credit derivative and related markets, as well as in the context of "traditional" securities trading.[9]

D. Focus on compliance with restrictions on affiliate transactions.[10]

1. Although Sections 23A and 23B of the Federal Reserve Act[11] by their terms do not apply to U.S. branches of international banks because such entities are not insured U.S. banks, Section 114(b)(4) of the GLBA explicitly authorizes the FRB to impose restrictions on transactions between a U.S. branch of an international bank and any U.S. affiliate if the FRB finds that such restrictions are consistent with applicable U.S. federal banking law and are appropriate to prevent decreased or unfair competition or a significant risk to the safety and soundness of U.S. banks.

(fn. cont.)

Memo No. 06-12 (March 17, 2006) (sales of market-indexed or linked certificates of deposit); NYSE Panel Decision 03-98 (June 4, 2003) (inappropriate sales practices related to callable certificates of deposit).

See generally Bank Activities Guide at Part IV.

9 See, e.g., Confidential Information Supplement to Loan Syndications and Trading Association [("LSTA")] Code of Conduct (October 2008), and Statement of Principles for the Communication and Use of Confidential Information by Loan Market Participants (LSTA, December 2006); Remarks of SEC Associate Regional Investor Rosenfeld (December 4, 2007) and of SEC Associate Director Firestone (November 19, 2007) (regardless of their effectiveness as a defense in private securities litigation, so-called "big boy" letters are no defense to an SEC enforcement action); Joint Statement of Industry Associations Regarding the Communication and Use of Material Non-Public Information (December 13, 2006); Joint Market Practices Forum Statement of Principles and Recommendations Regarding the Handling of Material Non-Public Information by Credit Market Participants (October 2003) and European Supplement (May 2005).

See generally Bank Activities Guide at Part II.E.1.c and Part V.A.3.d.

10 See generally Bank Activities Guide at Part III.A.6.

11 12 U.S.C. §§ 371c, 371c-1 ("Sections 23A/23B"), as implemented by the FRB's Regulation W, 12 C.F.R. Part 223 ("Regulation W").

2. Regulation W (12 C.F.R. § 223.61) applies Sections 23A/23B to cover transactions between a U.S. branch of an FBO (a "Covered Branch") and any affiliate (each a "Covered Affiliate") of such FBO directly engaged in the United States in the following activities: (a) non-credit-related insurance underwriting; (b) securities underwriting, dealing and market-making; (c) merchant banking (including portfolio companies held under that authority (see 12 C.F.R. § 225.125)); or (d) insurance company investment activities.

3. Areas of FBO compliance focus in the Section 23A/23B context include:

   a. The nature, scope, pricing and disclosure of affiliate service and support agreements.

   b. Satisfaction of the requirements for exemption from Section 23A of intraday extensions of credit by a Covered Branch to its Covered Affiliate (12 C.F.R. § 223.42(l)) that the Branch (i) establish and maintain policies reasonably designed to manage the credit exposure arising from such credit extensions in a safe and sound manner; (ii) has no reason to believe that the Affiliate will have difficulty repaying the extension of credit in accordance with its terms; and (iii) ceases to treat such extension of credit as an intraday extension of credit at the end of the Branch's U.S. business day.

   c. The application of the "attribution rule" (i.e., a transaction by a Covered Branch with any person is deemed to be a transaction with a Covered Affiliate "to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that [A]ffiliate").

   d. Application of Sections 23A/23B in the context of the "rebuttable presumption" (12 C.F.R. § 223.2(a)(9)) in the merchant banking context that a portfolio company is an "affiliate" of a Covered Branch if an FBO owns or controls 15% or more of the equity capital of the portfolio company.

   e. Support by a Covered Branch to funds advised by a Covered Affiliate (including through credit extension, cash infusion, asset purchases and acquisition of fund shares).

4. Once effective, the Dodd-Frank Act will add to the list of "covered transactions" under Section 23A: (a) the acceptance of debt obligations other than "securities" of an affiliate as collateral for a loan or extension of credit to a third party (acceptance of affiliate "securities" already is a covered transaction); (b) a transaction with an affiliate involving the borrowing or lending of securities to the extent that the transaction causes the bank to have credit exposure to the affiliate; and (c) a derivative transaction with an affiliate, to the extent that the bank will have credit exposure to the affiliate. In addition, Dodd-Frank also defines a "reverse repo" as an extension of credit (not as a purchase of assets), which will subject the transaction to Section 23A collateral requirements.

E. Focus on compliance with the anti-tying provisions of Section 106 of the Bank Holding Company Act ("BHCA") Amendments of 1970 (the "Anti-Tying Statute").[12]

The Anti-Tying Statute is applicable to U.S. branches of international banks and, in general and with some exceptions, prohibits a U.S. branch from conditioning the availability or pricing of a product or service (including an extension of credit) on a customer obtaining some additional product or service from the bank or one of its affiliates.

F. Focus on compliance with limitations and requirements (and on monitoring processes, documentation, approval and due diligence procedures) in respect of investments made by an international bank. Issues in this regard can relate to such matters as:

[12] See 12 U.S.C. §§ 1971; 68 Fed. Reg. 52024 (August 29, 2003) (solicitation of public comments) (Proposed FRB interpretation of the Anti-Tying Statute).

See also Bank Activities Guide at Part III.A.5.

1. U.S. federal banking authority being relied upon for such investment;[13] e.g.:

   a. The FRB's merchant banking rules.

   b. Treatment of merchant banking-type investments in financial services businesses (including credit unions, mortgage/consumer/commercial finance companies, broker-dealers, investment advisers/asset managers, commodity pool operators, futures commission merchants, money transmitters, check cashing operations, insurance companies, non-bank trust companies).

   c. Compliance with FRB guidance on private equity-type investments in banks/BHCs, savings associations/thrift holding companies, international banks with U.S. operations, industrial banks, Edge and Agreement corporations, non-bank banks, and similar banking entities.[14]

   d. Scope of the exemption from BHCA limitations for "investments in good faith in a fiduciary capacity" for investments in banks/BHCs, savings associations/thrift holding companies, non-bank banks and other depository institutions.

   e. Issues with respect to investments in real estate and/or physical commodities (including entities engaged in "volumetric production payment" financing, and entities engaged in "cash forward commodity purchase agreements") both as part of merchant banking and as permitted as part of the "business of banking".

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13 See BHCA § 4; 12 U.S.C. § 24(7); 12 C.F.R. §§ 7.1006, 211.8 et seq., 211.23, 225.170 et seq.;

See generally Bank Activities Guide at Part II.D, Part VII and Part XI.

14 See 12 C.F.R. § 225.144 (FRB Policy Statement on Equity Investments in Banks and [BHCs]); FDIC Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45440 (September 2, 2009), and FDIC Q&As (April 23, January 6, 2010).

f. BHCA §§ 4(c)(6)/4(c)(7): "passive," "non-controlling" investments in not more than 5% of any "class" of "voting securities", and less than one-third of the "equity", of a portfolio company ("4(c)(6) Investments"), or investments in an "investment company" limited to investments in debt "securities" and/or 4(c)(6) Investments.[15]

g. BHCA §§ 4(c)(9)/2(h)(2) and Regulation K (12 C.F.R. § 211.23): investments in certain foreign companies exclusively (or predominantly) engaged in business outside the United States.

h. BHCA § 4(c)(5): investments in small business investment companies ("SBICs").

i. Bank authority to (i) take as consideration for a loan, or for other banking services (A) a share in profits, income, production payments, earnings or property appreciation from a borrower, whether in addition to, or in lieu of, interest or other compensation for services, and/or (B) warrants, options or conversion or other rights to acquire equity; and (ii) invest in certain preferred securities and other equity instruments with debt-like characteristics.

2. Compliance with other applicable legal frameworks (e.g., Securities Exchange Act of 1934 (the "1934 Act"), Hart-Scott-Rodino Antitrust Improvements Act). Of particular relevance to FBOs are:

a. Legislation related to investments involving regulated industries (e.g., public utilities, power companies, entities with Federal Communications Commission licenses, "common carriers", real estate investment trusts, SBICs, insurance companies, casinos and gaming companies, mining

15 See generally Board Letter, dated December 15, 2009 (confirmation that Barclays PLC would not control BlackRock, Inc. for purposes of the BHCA as a result of Barclays (i) making an equity investment in BlackRock constituting 4.9% of the voting common shares and 19.9% of the total equity of BlackRock, (ii) having two director representatives on BlackRock's board, and (iii) having certain business relationships with BlackRock).

companies), requirements involving sovereign wealth funds, state law requirements); and

b. Compliance with the Foreign Investment and National Security Act ("Exon-Florio") as administered by the Committee on Foreign Investment in the United States ("CFIUS"); Exon-Florio provides for the review of certain transactions that could involve the acquisition by non-U.S. persons of "control" of U.S. businesses material to U.S. national security or which involve "critical infrastructure" or "critical technologies".[16]

(i) In general, the CFIUS review process is voluntary, except that (A) CFIUS is authorized to initiate its own investigations, and (B) the government retains the power to order that a transaction be unwound if it falls within Exon-Florio and was not notified and cleared.

(ii) Department of the Treasury regulations which implement Exon-Florio, and recent CFIUS actions, indicate that (A) the coverage of Exon-Florio can extend not only to the defense industry, but also to such sectors as aerospace, chemicals, information technology, energy, telecommunications and transportation, and (B) "control" can be found in "blocking rights" in covenants in debt instruments over "important matters" involving the borrower (e.g., the sale/lease/mortgage/pledge/transfer of principal assets, major corporate transactions, closing/relocation/substantial alteration of production/operations/research/ development facilities, major expenditures or investments, etc.). Accordingly, even loans to sensitive companies (e.g., government defense contractors, key infrastructure providers, telecommunications networks, etc.) could be subject to the special review, especially where an FBO -- as a

16 See 73 Fed. Reg. 74567 (December 8, 2008) (Department of the Treasury guidance describing CFIUS review process); 73 Fed. Reg. 70702 (November 21, 2008) (revised regulations).

foreign person -- is the sole lender or serves as the lead consortium bank.

3. Compliance with regulatory requirements applicable to the inter-relation between equity investments and other banking laws (e.g., Sections 23A/23B, the Anti-Tying Statute, "cross-marketing" restrictions, reporting requirements, etc.).

G. Recognition of the principal areas which generate Reputational Risk, including those arising from:

1. Participation in complex structured finance transactions ("CSFTs") and trading strategies driven by accounting, tax, regulatory or other avoidance motivations, or novel, complex or unusually profitable transactions that may raise "appropriateness" or "suitability" considerations insofar as marketing to, or selection of, counterparties is concerned.[17]

2. Transactions where the likelihood of customer confusion is enhanced (e.g., sale of non-deposit investment products through a bank or U.S. branch, or sale of non-U.S. bank obligations through a bank, U.S. branch or broker-dealer).

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[17] See Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities , 72 Fed. Reg. 1372 (January 11, 2007) (principles-based guidance with respect to CSFTs, focused on identification of "elevated risk" CSFTs, and risk management principles with respect to business ethics, diligence, reporting, documentation, monitoring, auditing, approval and management information processes, and training); FINRA News Release, October 12, 2009 (fine and censure of Citigroup Global Markets for failing to supervise complex trading strategies designed in part to minimize potential tax liabilities by arranging (i) a foreign client to sell U.S. equities to Citigroup's equity finance desk in New York, (ii) the New York desk to act as custodian of dividend-bearing stock for Citigroup's London affiliate, (iii) the London affiliate to use the stock as the underlying equity hedge in a "total return swap" entered into with the customer, and (iv) termination of the swap and sale of stock by the New York desk on behalf of the London affiliate -- with the end result that the foreign client received the full value of dividends from U.S. securities free of applicable U.S. withholding tax).

See generally Bank Activities Guide at Part II.E.2.f.

3. Transactions involving controversial public associations (political figures, etc.) or which involve dealing with unnamed counterparties.

4. Large but non-controlling investments, especially in companies in high risk economic (environmental, "sub-prime", gaming, power, etc.), political or geographic areas.

H. Identification and monitoring of <u>key risk indicators with respect to derivative transactions and trading activities</u>. Issues in this regard include: [18]

1. Recognition of responsibilities with respect to standards of fair practice, and policies, procedures and controls to guard against manipulative behavior.

2. Completion of "appropriateness" or "suitability" reviews of derivative clients and trading counterparties.

3. Depending on the nature of the asset underlying the derivative or trading activity, complying with other regulatory/licensing requirements (<u>e.g.</u>, receipt of Federal Energy Regulatory Commission authority to engage in market-based transactions in electricity, membership in "independent system operators" (ISOs) and "regional transmission organizations" (RTOs) to execute electricity derivative transactions).

4. Assuring appropriate policies and procedures with respect to contract review from an enforceability perspective, reporting and accounting, responsibility and authority, transaction processing, compliance-related supervision and Reputational Risk evaluation.

I. Review/evaluation of <u>outsourcing or offshoring contracts</u>. Appropriate due diligence, particularly of cross-border engagements, is increasingly important in respect of such matters as (1) security and confidentiality of bank and customer information; (2) monitoring of vendor performance, legal compliance systems and financial condition; (3) business continuity and disaster recovery; and (4) evaluation of "country risk" in terms of stability, applicability of foreign law and contract enforcement.[19]

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[18] <u>See generally</u> <u>Bank Activities Guide</u> at Parts II.B, II.D and II.E.

[19] <u>See generally</u> <u>Bank Activities Guide</u> at Part IX.B.

J. Focus on compliance with banking and securities law licensing/supervisory requirements in connection with international securities transactions/linkages. Attention to these issues will become increasingly important insofar as the Dodd-Frank provisions are concerned which affirm the authority of non-U.S. banks to rely on BHCA § 4(c)(9) in (1) the conduct of proprietary trading activities "solely outside the United States", and (2) the sponsorship and investment in hedge funds outside the United States, so long as interests in such funds are not offered for sale or sold to U.S. residents.[20]

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[20] See SEC Rule 15a-6 under the 1934 Act; SEC Release No. 34-58047 (June 27, 2008) (proposed amendments to Rule).

See also UBS, SEC Litigation Release No. 20905 (February 18, 2009) (settlement of charges that UBS acted as an unregistered broker-dealer and investment adviser to U.S. persons and offshore entities with U.S. citizens as beneficial owners); UBS Deferred Prosecution Agreement (February 18, 2009), United States v. UBS, Case No. 09-20423-CIV-GOLD/MCALILEY (S.D.Fla, February 19, 2009) (Petition to Enforce John Doe Summons), Stipulation of Dismissal (August 19, 2009), Department of Justice Release, August 19, 2009, Internal Revenue Service ("IRS") Release IR-2009-75 (August 19, 2009), Swiss Federal Department of Justice and Police Releases, August 19, 2009, June 17, 2010 (collectively reflecting agreement with Swiss Government to the effect that the IRS would submit a treaty request describing UBS accounts for which it is seeking information and the Swiss government would direct UBS to initiate procedures that could result in the turning over of information on thousands of accounts to the IRS); Tax Havens: International Tax Avoidance and Evasion (Congressional Research Service, July 2009); Senate Permanent Subcommittee on Investigations, Exhibits to Hearing on Tax Haven Banks and U.S. Tax Compliance: Obtaining the Names of U.S. Clients With Swiss Accounts (March 4, 2009).

The Hiring Incentives to Restore Employment Act, Public Law No. 111-147 (2010), includes key provisions of the Foreign Account Tax Compliance Act ("FATCA") that require (i) foreign financial institutions to report U.S. accounts or pay a 30% withholding tax on any withholdable payments made to the institutions or their affiliates, and (ii) U.S. persons with an interest in any "specified foreign financial asset" to file a report with the IRS relating to the asset in any year in which the asset exceeds $50,000. See also Senate Joint Committee on Taxation Technical Explanation of the [FATCA] (October 27, 2009).

In addition, Regions Bank, SEC Litigation Releases No. 21682 (October 4, 2010) and No. 21215 (September 21, 2009), involve a settlement of enforcement

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K. Evaluation of relationships between banks/broker-dealers and hedge funds, including in respect of service arrangements, brokerage compensation, disclosures, and treatment of hedge fund clients in comparison with other clients. Areas of review include those related to (1) custody/fraud protection; (2) conflicts of interest in the relationship between banks/broker-dealers and funds, such as in the context of the creation of "hedge fund hotels" at or near bank/broker-dealer premises; (3) the role of prime brokers; (4) supervision of broker-dealer employees physically located at hedge fund clients; (5) insider trading by hedge funds, particularly with respect to "private investment in public equity" (PIPE) transactions; and (6) "retailization" of hedge fund clients.[21]

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proceedings for Regions' actions in connection with mutual fund offering fraud against Latin American and other investors. As trustee of investment plans offered by U.S. Pension Trust Corp. and U.S. College Trust Corp. (collectively, "USPT"), Regions allowed USPT to use its name in marketing materials, prepared a promotional video that was posted on USPT's website, and sent representatives to Latin America to meet with sales agents and prospective investors to explain Regions' role as trustee. Regions entered into individual trust relationships with all investors, processed their contributions, and purchased the selected mutual funds for them. However, when it sent them confirming certificates (prepared by USPT but signed by a Regions representative), it failed to disclose the amounts taken out for USPT's fees and commissions. Regions' own Trust Agreement and Trust Summary were also misleading and failed to disclose the nature and amounts of the commissions and fees that USPT charged.

See generally Bank Activities Guide at Part XI.

21 See, e.g., IOSCO Media Release, February 25, 2010 (template for the global collection and exchange of information relating to the activities of hedge funds for the purpose of facilitating supervisory cooperation in assessing possible systemic risks); Assessing Possible Sources of Systemic Risk for Hedge Funds (FSA, February 2010).

The SEC is conducting an inquiry into whether funds of hedge funds and advisors that collect fees from funneling investors into hedge funds are properly dealing with potential conflicts of interest. The SEC has initially identified for questioning about a dozen investment advisory firms overseeing $100 million to $15 billion in assets, but the inquiry could expand to include other investment advisory firms, including

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L. Focus on joint marketing arrangements in which a third party uses the bank's name and logo in connection with a product primarily offered by the third party.[22]

M. Focus on compliance with Bank Secrecy Act ("BSA")/USA PATRIOT Act/Office of Foreign Assets Control ("OFAC") requirements, including in respect of (1) anti-money laundering ("AML") programs, (2) suspicious activity reports ("SAR") tracking/monitoring/filing, (3) implementation of adequate customer identification/know-your-customer procedures, (4) trade finance, (5) foreign correspondent account review, and (6) diligence in respect of U.S. and non-U.S. shell companies and tax havens.[23]

1. The Comprehensive Iran Sanctions, Accountability and Divestment Act, Public Law No. 111-195 (July 1, 2010), substantially increases both the activities that may lead to sanctions on U.S. and foreign persons which deal with Iran and the potential severity of those sanctions.

2. Significant enforcement actions continue against financial institutions (including, in 2009 and 2010, ABN AMRO, Barclays Bank, Credit Suisse, HSBC, Lloyds, Société Générale and Wachovia) for BSA, OFAC and related violations. Most of the major enforcement actions

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those focused on private equity and pension funds. See Wall St. J. (September 10, 2010).

See generally Bank Activities Guide at Part II.D.4.

22 See "Third-Party Arrangements: Elevating Risk Awareness", FDIC Supervisory Insights (Summer, 2007). See also, e.g., SEC Admin. Proc. No. 3-12809 (September 19, 2007) (settled enforcement proceedings against HSBC Bank USA, N.A., with respect to use of its name and logo in connection with a fraud by Pension Fund of America, which raised more than $125 million from more than 3,400 investors, primarily from Central and South America).

23 See Interagency BSA Examination Manual; Risk Factors for OFAC Compliance in the Securities Industry (Department of the Treasury); A Review of Current and Evolving Trends in Terrorism Financing (National Security Law and Policy Investigative Project on Terrorism, September 28, 2010).

See generally Bank Activities Guide at Part VIII.A.

have involved failure to detect and report suspicious activity or otherwise comply with sanctions requirements, which is then treated as an indication of failure to maintain an effective compliance program. Recent enforcement actions reflect such matters as (a) lack of management oversight and accountability; (b) failure to meet reporting requirements; (c) failure/absence of key controls; (d) inadequate risk assessment; (e) inadequate/ineffective monitoring functions; (f) due diligence failures; (g) inadequate communication of information; (h) failure to correct a previously reported problem or to respond to previous criticism; (i) inappropriate "stripping" or resubmission of wire transfer instructions; and (j) concealing information from examiners.

3. Key elements of SAR/AML programs identified in recent enforcement orders include the importance of a financial institution (a) fostering a culture of compliance with a "tone" clearly set "at the top"; (b) ensuring that the compliance function is adequately led, staffed and supported; (c) maintaining detailed and up to date written policies that specifically address the institution's risks; (d) assuring that policies are followed, that customer identification programs are robust, and that documentation (including of any exceptions to policy implementation) is accurate and complete; (e) understanding the normal/expected transactions of each customer and periodically reviewing a customer's account activity to update the parameters of "normal" activity if necessary; (f) establishing a methodology to assign risk levels to different types of customers and products; (g) providing enhanced due diligence for customers, products and geographic areas that pose higher risks; (h) establishing internal procedures for reporting information about potentially suspicious transactions; (i) engaging senior management in the process of identifying and reviewing significant issues; (j) conducting rigorous independent testing; (k) ensuring that information received from subpoenas and other law enforcement inquiries is included in risk assessments; (l) responding quickly and fully to regulatory criticism and to issues identified by independent testing; and (m) complying with SAR confidentiality requirements.

4. In evaluating OFAC related issues, it is important to recognize that (a) OFAC regulations assert jurisdiction over all U.S. persons, wherever located; (b) OFAC regulations target direct and indirect relationships; (c) OFAC regulations prohibit not only transacting and dealing in assets, but also the provision of services (financial and otherwise), as well as (in some cases) the approval or facilitation of

services provided by others; (d) OFAC requirements are implemented by relationships, transactions or dealings of any type that could touch the U.S. financial system, or that are supported by the U.S. financial system; (e) OFAC sanctions are a strict liability regime (with no defenses based on lack of knowledge or intent); and (f) reference to OFAC categories and lists (e.g., of designated countries or governments, or of "specially designated nationals" ("SDNs")) is not enough to assure compliance; rather, sanctions may be unrelated to the geographic location, nationality or government status of a particular party, and may apply not only to SDNs, but also to other entities that derive most of their operating income from sanctions targets or hold most of their assets in such targets.

5. OFAC Economic Sanctions Enforcement Guidelines, 74 Fed. Reg. 57593 (November 9, 2009),[24] set forth a list of General Factors that OFAC will consider in determining what type of enforcement action to take (e.g., cautionary letter, civil penalty, criminal referral) and in establishing the amount of any civil money penalty.

   a. The General Factors include (i) willfulness or recklessness in causing a violation of law; (ii) awareness of the conduct giving rise to the apparent violation; (iii) the actual or potential harm to sanction program objectives caused by the conduct in question; (iv) the commercial sophistication and experience of the alleged violator, the volume of transactions at issue and any history of sanctions violations; (v) the existence and nature of the applicable OFAC compliance program at the time; (vi) corrective actions taken; (vii) the nature and extent of cooperation with OFAC; (viii) the timing of the apparent violation in relation to the adoption of applicable prohibitions; (ix) other federal or state enforcement actions already taken; and (x) the impact administrative action may have on promoting future compliance with U.S. economic sanctions.

   b. Voluntary self-disclosure is a major factor in establishing a penalty amount, as is the egregiousness of the violation in question (with substantial weight given to considerations of willfulness or recklessness, awareness of the conduct giving

24 Appendix to 31 C.F.R. Part 501.

rise to an apparent violation, harm to sanctions program objectives, and the individual characteristics of the alleged violation).

6. Scrutiny of internationally active banks by OFAC is increasing, wherever they are based.

    a. In recent years U.S. bank examiners and OFAC have been intensifying reviews of letters of credit advising or confirming and U.S. dollar clearing for adequacy of identifying information.

    b. Dollar clearing is a key source of sanctions exposure; a U.S. branch of an FBO (and potentially a non-U.S. parent) may be liable for OFAC violations if it clears dollars for sanctions targets, even indirectly (e.g., for a correspondent bank).

    c. OFAC requires banks to implement risk-based policies and procedures specifically for OFAC compliance (in addition to their AML policies).

7. Following an enforcement action, special attention must be given to (a) satisfying enhanced regulatory expectations; (b) as needed, clarifying or seeking a modification of deadlines for addressing open terms; (c) fully engaging internal/external auditors/consultants/ counsel as necessary; and (d) developing a clear action plan in terms of implementation, prioritization, exception requests and reporting.

N. Focus on compliance with the Foreign Corrupt Practices Act (the "FCPA").[25]

1. The FCPA prohibits the bribery of foreign officials, and requires U.S. 1934 Act-reporting companies to maintain certain books, records and systems of internal accounting controls.

[25] See 15 U.S.C. §§ 78m(b)(2)-(7); 78dd-1, 78dd-2, 78dd-3, 78ff; SEC Rules 13b2-1, 13b2-2. Compare OECD Anti-Bribery Convention: Progress Report 2008 (Transparency International, 2008); 2008 Anti-Bribery and Anti-Corruption Survey (KPMG, 2008).

See generally Bank Activities Guide at Part VIII.A.4.

2. Insofar as an FBO is concerned, subject to certain exceptions, the "bribery" provision bars any act by any U.S. office or subsidiary of the FBO in furtherance of a corrupt payment, offer or promise to pay, or authorization of any payment of money or anything of value to a "foreign official" to obtain or retain business or secure an improper advantage. In addition, these payments cannot be offered, promised or authorized to or for a third party while "knowing" that any portion of the payment will be passed on to a foreign official.

   a. The scope of the term "foreign official" is potentially broad enough to cover such persons as officers of nationalized banks and foreign state-owned enterprises, and managing directors of sovereign wealth funds.

   b. In addition, care is required if an entity intends to rely on any of exceptions to the FCPA's prohibitions -- including payments "lawful under the <u>written</u> laws and regulations" (emphasis added) of the relevant country and certain other defined "reasonable and <u>bona</u> <u>fide</u> expenditure".

   c. Many FCPA investigations involve third parties, such as agents, consultants and other vendors or distributors.

3. Historically, banks, broker-dealers, investment advisers and other financial services firms have not been the focus of FCPA enforcement actions, but recent developments -- such as FINRA Letter, dated March 9, 2009, which, for the <u>first time</u>, included FCPA compliance in its broker-dealer examination priorities -- make clear that financial services firms will be the subject of FCPA-related scrutiny.

4. There has been a substantial increase in the number of enforcement actions brought against companies and individuals and the size of the financial penalties imposed.

   a. More FCPA prosecutions have been brought by the Department of Justice (the "<u>DOJ</u>") since 2005 than in the entire period from the FCPA's enactment in 1977 to 2005. Since 2004 the DOJ has charged approximately 40 corporations and 80 individuals with foreign bribery-related offenses, and has indicated that, in 2010, it is pursuing 140 active FCPA investigations, up from 120 a year earlier.

b. The passage of Dodd-Frank may affect FCPA compliance and enforcement. Section 922 of the Act requires the SEC to pay an award ranging from 10% to 30% of any monetary penalty of greater than $1 million to whistleblowers who voluntarily provide the SEC with information leading to a successful prosecution of a violation of the securities laws, including the FCPA. This may create a significant incentive for employees to report perceived FCPA violations directly to the SEC in hopes of receiving a cash reward, rather than reporting through internal corporate channels. (In addition to the whistleblower provision, Section 1504 of the Act requires any business that files an annual report with the SEC and that is engaged in the commercial development of oil, natural gas or minerals, to disclosure in annual filings certain payments made to foreign governments – including legitimate and legal payments – related to the development of oil, natural gas and minerals.)

5. Steps that a U.S. branch or subsidiary of an FBO can take to minimize the risk that it will violate provisions of the FCPA could include the following:

a. A system of internal accounting controls that would detect unauthorized or illegal transactions; in particular, such a system should require that (i) all cash disbursements and other asset transfers be recorded promptly, (ii) employees have access to corporate assets only pursuant to specific or general authorization from senior management, and (iii) the recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken to address disparities.

b. A written code of conduct strictly forbidding all corrupt payments to non-U.S. officials and public international organization officials.

c. A requirement that background investigations be conducted of consultants or agents and that FCPA compliance provisions be included in all appropriate contracts.

d. A requirement that the U.S. branch's or subsidiary's officers and its consultants or agents annually certify that they have not made improper payments.

e. Investigation of any "red flags" that come to the U.S. branch's or subsidiary's attention.

O. Focus on information security, particularly in light of increased instances of identity theft.[26]

P. Sensitivity to special concerns relating to broker-dealer/investment adviser and related compliance responsibilities.

1. Compliance with the SEC's "Dealer Push-out Rules", which limit the activities of U.S. banks and U.S. branches of international banks, as principal, involving certain securities. Open issues in this context relate to (a) how repurchase transactions on securities which are not exempt securities or "identified banking products" should be treated for purposes of the limited continuing exemption for banks from "dealer registration"; (b) whether cash/physically settled forward transactions should be characterized as "identified banking products"; (c) the scope of the applicable bank dealer exemption in the context of hedges of equity/credit derivative transactions; and (d) the treatment of loan participations which do not fall literally within the scope of "identified banking products".[27]

2. Compliance with the SEC's "Broker Push-out Rules" as reflected in Regulation R.[28]

3. Top areas of interest for current SEC/FINRA broker-dealer examinations include:[29]

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26 See generally Bank Activities Guide at Part IX.F.

27 See SEC Release No. 34-47364 (February 24, 2003); SEC Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules (September 2003).

See generally Bank Activities Guide at Part II.C and Part II.D.3.b.

28 See 12 C.F.R. Part 218.

See generally Bank Activities Guide at Part IX.B.4.

29 See, e.g., SEC Press Release No. 2010-165 (September 7, 2010) (administrative proceeding charging investment adviser with unsuitable recommendations and misrepresentations in connection with sales of hedge funds); FINRA New Release,

fn cont.

a. Maintenance of an appropriate "culture of compliance", including (i) compliance oversight; (ii) codes of conduct; (iii) identification and control of compliance risks; (iv) implementation of effective supervisory systems; (v) communication, education and training; (vi) internal processes to monitor and audit the compliance system; (vii) implementation of comprehensive policies, procedures, systems and controls tailored to the broker-dealer's business; (viii) effective reporting and resolution of significant compliance issues; and (ix) response to violations and sanctioning of non-compliant actions.

b. Whether supervisory and compliance procedures are comprehensive, updated, appropriately tailored to the broker-dealer's business and being followed (including with respect to AML and FCPA requirements, branch office operations, independent contractors and outsourcing arrangements), and the status and function of compliance officers.

c. Conflicts of interest, including (i) disclosure-related issues (e.g., payments by mutual funds to broker-dealers and the use of soft dollars); (ii) misuse of customer trading information or other non-public information; (iii) allocation of limited products, services or opportunities to favored clients or

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August 19, 2010 (fine of broker-dealer for unsuitable sales of inverse floating rate collateralized mortgage obligations and failure to explain fully risks of such investments); FINRA News Release (August 10, 2010) (deficient conflict of interest disclosures in equity research reports and public appearances by research analysts); FINRA News Release, July 22, 2010 (fine of broker-dealer for unsuitable unit investment trust, closed-end fund and mutual fund transactions); FINRA News Release, July 21, 2010 (fine of broker-dealer for negligently misrepresenting delinquency data in connection with the issuance of subprime securities); SEC Litigation Release No. 21592 (July 15, 2010) (administrative proceeding charging broker-dealer and one of its employees with securities fraud for failure to disclose to investors in a synthetic collateralized debt obligation ("CDO") that a hedge fund with economic interests adverse to the investors played a significant role in the selection of the reference portfolio for the CDO).

See generally Bank Activities Guide at Part IX.E.

provision of special incentives or payments for use of products or services; (iv) use of products or services of affiliates or favored clients; (v) playing multiple roles in a transaction or with respect to an issuer or client; (vi) biased research and advice; (vii) accounting, booking or reporting to achieve other interests; and (viii) gifts and entertainment to and from clients.

d. Sales practices (including suitability, disclosure of risks, costs and fees, unauthorized trading, cold calling, churning, switching, misrepresentation of performance results and recommending home mortgages to fund securities purchases), with special emphasis on municipal interest rate swaps, leveraged exchange-traded funds, fee-based accounts, sales and marketing to senior citizens, separately managed accounts, variable annuities, "Section 529" college savings plans, penny stocks, private placements, principal protection notes, illiquid or volatile securities, underwritings and distributions, money market funds and hedge funds.

e. Trading and pricing practices (including insider trading, front-running, order entry controls, misuse of customer trading data or other non-public information, brokerage arrangements, satisfaction of best execution responsibilities (including in the context of mark-ups (e.g., on corporate and municipal bonds), and in the context of "bundled" commissions and the pricing of principal and agency trades)).

f. The manipulation of securities prices through false information.

g. Internal controls (including separation of banking from research), disclosure (including through ADV filings, performance advertising, marketing, fund prospectuses and other information provided to clients), risk management (including Credit Risk, Operational Risk and Legal Risk), internal audit, reporting (including data integrity), books and records, e-mail retention, and inventory and collateral valuations (including of structured products, especially subprime mortgage-related products).

h. New products (including the creation and marketing of structured finance products and the new product approval process).

i. Financial issues (including net capital and reserve account deficiencies and inaccuracies in computing net capital or reserve requirements).

j. Policies and procedures for the safeguarding of customer assets from theft, loss, misuse and misappropriation (including by reviewing existing custodial and prime brokerage arrangements), and other custodial risk issues (particularly as they relate to investment advisers which "self-custody" client assets).

k. Outside business activities of registered representatives (including mortgage brokers and sellers of hedge funds and variable insurance products).

l. Information security (including protection of customer information within the firm and in the context of outsourcing arrangements, on-line brokerage account intrusions, compliance with "identity theft" regulations, and "leaking" of information about large trades to favored customers).

m. Business continuity programs.

n. How the broker-dealer identifies and responds to "red flags" given the nature of its business.

o. Nature and scope of cooperation with regulatory inquiries.

p. Short selling.

q. Bank sweep programs.

r. Securities lending programs, particularly with respect to customer fully paid securities.

s. Compensation or payment arrangements that may be part of revenue sharing or other undisclosed arrangements (including payments to increase fund sales or assets under management, or misappropriation of adviser/fund/broker-dealer assets through the creation of fictitious expenses, or kick-backs from service providers).

t. Interaction with credit rating agencies (including the agencies' disclosure of the assumptions underlying their methodologies, sources of fee compensation and factors that could change ratings).

u. Credit default swaps, asset-backed securities and other derivatives or similar investments.

v. Non-securities activities, particularly foreign exchange trading and sales.

4. With respect to investment advisers/investment companies, recent areas of compliance interest include:[30]

a. Disclosure (including in respect of client risks, directed brokerage arrangements, fees, "mixed use arrangements" involving "soft dollar" and administration fees).

b. Conflict of interest disclosure/resolution (including in respect of trade allocations among clients, side-by-side management of hedge funds and "pay-to-play" arrangements (political contributions by investment advisers made for the purpose of obtaining or retaining advisory contracts with government entities)).

c. Custody/safety of client/fund assets (including securities lending and delivery of account statements).

d. Portfolio management controls to ensure that client investments are consistent with client mandates, risk tolerance and goals.

e. Personal trading issues (including codes of ethics and controls to prevent insider trading and front-running).

f. Brokerage arrangements and satisfaction of best execution responsibilities.

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30 See, e.g., North American Securities Administrators Association News Release, September 29, 2009 (Best Practices for Investment Advisers).

See generally Bank Activities Guide at Part VIII.C.2.

g. Compliance and supervision programs (including in respect of portfolio management and dealings with elderly investors).

h. Fund shareholder trading (market timing, late trading, etc.).

i. Transactions with affiliates (including favoritism, abusive/undisclosed transactions, and payments involving use of client assets).

j. Advertising/marketing and performance claims.

k. Fair value pricing and valuation controls.

l. Fees (including performance, administrative and "soft-dollar" fees).

m. Information processing and protection.

n. Proxy voting for clients (including documenting procedures and disclosure)

o. Compliance reviews of fund intermediaries.

p. Short sales (including compliance with new disclosure rules and anti-fraud measures).

q. Money market funds (including issues relating to excessive risk-taking and compliance with requirements relating to shadow pricing procedures and creditworthiness of portfolio securities).

r. Compliance with the FCPA.

ROBERT L. TORTORIELLO
CLEARY GOTTLIEB STEEN & HAMILTON LLP
Tel. No.: 212-225-2390
E-mail: rtortoriello@cgsh.com

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax