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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 <u>as Bank Holding Companies and Financial Holding Companies</u>

Operational Risk Management Issues <u>from a Regulatory and Compliance Perspective</u>

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Operational Risk Management Issues from a Regulatory and Compliance Perspective[1]

I. Introduction

Operational risk has become an increasingly critical 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 all aspects of 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, among other things (i) internal fraud (an

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1 This Outline is intended to highlight certain selected legal/regulatory compliance developments over the past several months related to regulation and supervision of branches, agencies and subsidiaries of international banks. It is intended to be current as of October 20, 2006.

2 For recent regulatory and other background and discussion of operational and related risks, see, e.g., "Operational Risk", Federal Deposit Insurance Corporation ("FDIC") Supervisory Insights (Summer, 2006); Remarks of Board Governor Olson, May 16, 2006 ("Compliance Risk Management in a Diversified Environment"); Enhancing Corporate Governance for Banking Organizations (Basel Committee on Banking Supervision ("Basel"), Feb. 2006); Sound Practices for Managing Legal Risk: Principles for Legal Departments in Financial Institutions (Federal Reserve Bank of New York, 2006); American Banker, September 29, 2006 ("How to Minimize Risk of Tail-Event Damage").

See also Tortoriello & Glotzer, Guide to Bank Underwriting, Dealing and Brokerage Activities (Thomson LegalWorks, 11th ed., 2006) (the "Bank Activities Guide") at Part II.A.

intentional act intended to defraud, misappropriate property or circumvent the law or bank policy); (ii) external fraud; (iii) employment practices (e.g., an act inconsistent with employment, health or safety laws or agreements or a diversity/discrimination event); (iv) clients, products and business practices (an unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements)); (v) damage to physical assets (natural disaster or other events); (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 in wide-ranging business lines such as (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 -- and, consequently, operational losses have the potential to be of great magnitude. A 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 84% of executives surveyed by the Economist in 2005 believe that the threat to their companies' reputations has increased significantly over the past five years and that compliance failures are the biggest source of reputational risk.[3]

[3] See Reputation: Risk of Risks (Economist Intelligence Unit, December 2005). See also Reputation Damage: The Price Riggs Paid (WorldCheck, 2006).

2. Since Basel II resolves the debate between "Pillar 1" or "Pillar 2" treatment of Operational Risk in favor of "Pillar 1", 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.[4]

   a. National regulators will still need to resolve ongoing debates as to the recognition of Operational Risk mitigants, including (i) the maximum amount of the Operational Risk capital charge that may be offset (Basel II: 20%); (ii) the nature of the mitigants to be recognized (Basel II: insurance only, although the Basel Committee "may consider revising the criteria for and limits on the recognition of Operational Risk mitigants on the basis of growing experience"); and (iii) the impact of outsourcing of various functions and controls.

   b. The costs of Basel II Operational Risk compliance are expected to be significant, with estimates ranging as high as $100 million - $200 million over five years.

   c. The Basel 2006 AMA Report showed continued challenges in moving forward in operational risk management under the AMA approach, including (i) the nature and extent of active involvement required of a bank's board and senior management in the oversight of the operational risk management framework; (ii) how to best maintain the independence of the operational risk management function; (iii) how to carry out most effectively an independent

[4] See generally Observed Range of Practice in Key Elements of Advanced Measurement Approaches ("AMA") (Basel, October 2006) (the "Basel 2006 AMA Report") (describing specific practices banks opting for the AMA approach have adopted in their operational risk-related work in regard to internal governance issues, data issues and modeling/quantification issues); Report on International Developments in Banking Supervision (Basel, September 2006); Results of the Fifth Quantitative Impact Study (QIS 5) (Bank for International Settlements, June 16, 2006); Core Principles for Effective Banking Supervision (Basel, April 2006); Core Principles Methodology (Basel, April 2006); Principles for the Home-Host Recognition of AMA Operational Risk Capital (Basel, January 2004); Basel II -- A Closer Look: Managing Operational Risk (KPMG, 2003); The Compliance Function in Banks (Basel, October 2005); Sound Practices for the Management and Supervision of Operational Risk (Basel, February 2003).

assessment by internal and/or external parties of the bank's operational risk management and measurement framework, given the paucity of operational loss data and the early stage of development of AMA models; and (iv) the need for banks to substantiate how they quantify the impact of "business environment and internal control factors" (e.g., rate of growth, new product introductions, internal audit results, employee turnover, system downtime) on the AMA capital calculation.

3. The "Pillar 2" principle of supervisory review also appears critically relevant to Operational Risk management:

   a. A financial institution should have a process for assessing its overall capital adequacy in relation to its risk profile and a strategy for maintaining its capital level, including (i) board and senior management oversight; (ii) policies and procedures to identify, manage and report risks, relate capital to the level of risk, state capital adequacy goals with respect to risk, and incorporate controls, reviews and audits to insure the integrity of the risk management process; (iii) comprehensive risk assessment, including the institution's appetite and tolerance for Operational Risk; (iv) a system for monitoring and reporting risk exposures to the institution's senior management and board of directors; and (v) an internal control review structure.

   b. A financial institution should be able to demonstrate the effectiveness of its internal capital adequacy assessments and strategies, and its ability to monitor and ensure compliance with regulatory capital ratios.

   c. A financial institution should operate above the minimum regulatory capital ratio applicable to the volume and scope of its business risks.

4. Reconciliation of Regulatory Overlap for the Management and Supervision of Operational Risk in U.S. Financial Institutions (Financial Services Roundtable, May 20, 2005) concludes that a review of applicable banking and securities laws -- including the Federal Deposit Insurance Corporation Improvements Act (FDICIA), the Gramm-Leach-Bliley Act (the "GLBA"), the Sarbanes-Oxley Act, and Basel AMA with respect to Operational Risk capital charges -- reveals certain common principles, including:

a. A greater emphasis on financial institutions' internal control systems and processes, and their impact on operational risk.

b. Heightened requirements for risk control assessment documentation and supporting evidence of control systems.

c. The need for clarity around roles and responsibilities regarding board of directors and senior management oversight of internal control systems, with specific accountability and penalties for non-compliance directed at responsible individuals and entities.

d. Concern for the accuracy and transparency of financial reporting (market discipline) and related controls.

e. An increased need for Operational Risk data collection and quantitative processes.

f. Better alignment of minimum regulatory capital requirements with the risk profiles of financial institutions, specifically with regard to operational risks and internal control systems.

B. Scope of U.S. Regulation and Supervision Over Operational Risk Considerations at U.S. Branches and Subsidiaries of International Banks[5]

1. "Home Country" v. "Host Country" Supervisory Focus

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

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

[5] For purposes of this Outline, the term "U.S. branch" of an international bank encompasses U.S. agencies as well.

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 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. Potential areas of difficulty in implementing operational risk standards for an international banking operation involve (i) home-host supervisory cooperation, and (ii) the proposed bifurcated application of Basel II in the United States and the special issues it creates for cross-border banking.

(i) Banking organizations have expressed significant concerns about the prospect of each national supervisor asking different questions about Basel II 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 II capital requirements for Operational Risk.

(ii) On the one hand, Basel II 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). The Basel Supervisors' Committee has thus proposed that "significant" subsidiaries calculate <u>stand-alone Operational Risk capital requirements</u> that may not incorporate group-wide diversification benefits. Other subsidiaries will be permitted to use an allocated portion of the group-wide requirements, but host-country supervisors will have the right to demand more capital than may result from such allocations. Thus, both of these proposals may well result in the sum of the individual legal-entity capital requirements being greater than the consolidated-entity requirements.

(iii) The <u>U.S.</u> application of Basel II also raises special concerns. In the context of Operational Risk, in contrast to the rest of the world, it is still an open question in the United States as to whether banking organizations will be required to adopt only the AMA approach to the management of Operational Risk.

(a) For international banks, the issue is the additional complexity and perceived inequity they will face if they operate in the rest of the world under the foundation approach.

(b) For U.S.-based banks the fear is that international rivals may get a competitive edge for one year through lower regulatory capital requirements in some markets, since the permissible start date for Basel Accord implementation outside the United States will precede U.S. implementation.

(iv) 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 exam rating could adversely affect the bank's status as a "financial holding company" (an "FHC") under the GLBA.

d. Key principles of facilitating effective host/home country supervisory coordination include:

(i) Transparency -- 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 under Basel II.

(ii) Coordination -- 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) Pro-active Problem Resolution -- 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) Commitment of Resources -- both in terms of senior management attention to host/home supervisory issues and in terms of support for the compliance/legal/audit function.

2. Risk Management Trends in Diversified Financial Companies

While financial firms have traditionally taken a more segmented approach to risk measurement and control (i.e., focusing on risk management by business line, or by regulated entity within a consolidated group), banking regulators have increasingly focused a more holistic view of risk, and there appears to be an increasing emphasis on consolidated, cross-entity risk management and reporting. An integrated compliance approach is emerging: an independent centralized function responsible for implementing Operational Risk policies, independent of business lines. This involves a recognition that consolidated risk management involves not only an attempt to quantify risk across a diversified firm, but also a much broader process of business decision-making and support of management to make informed decisions about the extent of risk taken both by individual business lines and by the firm as a whole.[6]

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

A. General Approach

1. 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 and concerns.

3. 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.

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,

6 See generally Bank Activities Guide at Part I.A.5.f.

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. A robust internal audit process which focuses on independence, planning, risk assessment, exception tracking and resolution.

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 focus seems to be shifting from a compliance model focused primarily on adherence to existing laws and regulations to one that targets a more complete involvement in enterprise-wide risk management, creation of firm-wide compliance values, evaluation of firm-wide business practices, and construction of firm-specific "best practice" models.

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

a. Attention from the board of directors and senior management.

b. Employee training and self-assessments.

c. Procedures for prompt redress of reporting problems.

d. Cooperation with regulators.

e. Closer integration of the governance, risk management and compliance functions.

f. Limitations on outsourcing the compliance function.

6. The biggest problems from an Operational Risk perspective are likely to arise for financial institutions if:

a. Compliance problems are allowed to fester.

b. Conflicts of interest are not pursued and addressed.

c. Internal audits or compliance revisions are done in a cursory manner, or their results are either ignored or not acted on.

d. Bank Secrecy Act ("BSA")/USA PATRIOT Act/Office of Foreign Assets Control ("OFAC") requirements (including, in particular, those respecting suspicious activity reports ("SARS")) are neglected.

e. Reputational Risk issues are not given serious attention -- it is not always enough to say "it's legal" to satisfy and properly address this risk.

B. Complex Structured Finance Transactions

1. The use of derivatives and other complex structured finance transactions ("CSFTs"), and the role of banks and other financial institutions in structuring CSFTs for customers, have come under scrutiny in the wake of the Enron bankruptcy and related regulatory actions and litigation. These actions and proceedings show an increased willingness on the part of courts and regulators to hold financial institutions responsible for participating in transactions that may be deceptive or improperly reported.[7]

2. The Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 71 Fed. Reg. 28386 (May 16, 2006) (adopting release and solicitation of public comments) (the "Interagency Statement on CSFTs"), offers principles-based guidance to banks and other financial transactions with respect to their involvement in CSFTs. Though substantially changed in the comment and revision process, the Interagency Statement on CSFTs began with a Proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. 28980 (May 19, 2004) (the "Proposed Interagency Statement on CSFTs").

a. The Interagency Statement on CSFTs focuses on the identification and management of "elevated risk CSFTs" (those CSFTs that pose substantial or unusual levels of legal or reputational risk) based on the following principles and recommendations:

(i) Identification of elevated risk CSFTs.

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

(a) The Interagency Statement on CSFTs would require financial institutions to establish and maintain policies, procedures and systems to identify elevated risk CSFTs, such as CSFTs that appear to:

(i) Lack economic substance or business purpose.

(ii) Be designed or used for questionable accounting, regulatory or tax objectives (particularly at year-end or the end of a reporting period).

(iii) Raise concerns that the client will disclose or report in a materially misleading manner.

(iv) Involve circular transfers of risk that lack economic substance or business purpose.

(v) Involve oral or undocumented agreements that would have a material impact on regulatory, tax or accounting treatment or disclosure obligations.

(vi) Have material economic terms that are inconsistent with market norms (e.g., deep "in the money" options or historic rate rollovers).

(vii) Provide the financial institution with compensation disproportionate to services, or to the Credit, Market or Operational Risk assumed by the institution.

(b) A financial institution may find it helpful to incorporate the review of new CSFTs into its new product policies (including a control process for the approval of new CSFTs). (An institution may consider a number of factors in determining whether a CSFT is "new," including (i) structural or pricing variations from existing products; (ii) whether the product targets a new class of customers or a new need of customers; (iii) whether the CSFT raises new compliance, legal or regulatory issues; and (iv) whether the CSFT would be offered in a manner that would deviate from standard market practices.

(c) A financial institution operating in jurisdictions outside of its "home country" should tailor its policies and procedures to account for the laws, regulations and standards of those jurisdictions. U.S. branches of international banks should coordinate their policies with the bank's group-wide policies and should implement a control infrastructure for CSFTs that is consistent with the institution's overall structure and framework for risk management and controls.

(ii) Due diligence.

(a) The Interagency Statement on CSFTs would require a financial institution to implement policies and procedures for heightened due diligence of transactions identified by the institution as elevated risk CSFTs. The level of diligence should be consistent with the levels of risk identified and the role of the institution in the CSFT (e.g., whether it serves as an adviser).

(b) The Interagency Statement on CSFTs notes that an institution may find it useful or necessary to obtain additional information from a customer, or to obtain specialized advice from accounting, tax, legal or other professionals.

(iii) Approval process.

(a) A financial institution should have policies to ensure review and approval of elevated risk CSFTs by appropriate levels of control and management personnel with sufficient experience, training and organizational stature, including representatives of appropriate control areas that are independent of the business lines involved.

The Interagency Statement on CSFTs notes that some institutions have established senior management committees designed to include all of the relevant control functions (e.g., independent risk management, accounting, policy, legal, compliance and financial control) in the approval and oversight of elevated risk CSFTs. Although the Statement notes that such a management committee may not be appropriate for all institutions, it emphasizes that a financial institution should establish a process to manage elevated risk CSFTs consistently on a firm-wide basis.

(b) An institution should take steps to address significant legal or reputational risks, which may include declining to participate in the transaction, modifying the transaction or conditioning participation upon receipt of representations or assurances from the customer that reasonably address heightened legal or reputational risks. An institution should decline to participate if it determines that the transaction presents unacceptable risk or would result in a violation of law, regulation or accounting principles.

(iv) Documentation.

(a) A financial institution should create and collect sufficient documentation to:

(i) Document the material terms of the CSFT.

(ii) Enforce the material obligations of counterparties.

(iii) Confirm that customers have received any required disclosures concerning the CSFT.

(iv) Verify that policies are being followed and allow internal audit to monitor compliance with those policies.

(b) Where a financial institution's policies require senior management approval of an elevated risk CSFT, the institution should maintain documentation presented to management and documentation reflecting approval or disapproval, any conditions imposed by senior management and the reasons for such action.

(v) Other risk management principles include:

(a) General business ethics*:* The board of directors and senior management should establish a "tone at the top" to create a firm-wide culture and procedures that are sensitive to ethical or legal issues as well as potential risks to the institution. The Interagency Statement on CSFTs notes that a financial institution may need to consider implementing mechanisms to protect personnel by permitting confidential disclosure of concerns.

(b) Monitoring*:* A financial institution should conduct periodic independent reviews of CSFT activities to verify that procedures and controls are being implemented effectively and that elevated risk CSFTs are identified accurately and receive proper approvals.

(c) Training*:* Relevant personnel involved in CSFTs should be familiar with the financial institution's policies and procedures, including processes for the identification and approval of elevated risk CSFTs and new CSFTs and for elevating concerns to appropriate levels of management.

(d) Audit*:* Internal audit should audit the financial institution's compliance with its policies (and the adequacy of such policies related to elevated risk CSFTs). Periodic validations should include transaction testing.

(e) Reporting*:* A financial institution's policies should provide for the appropriate levels of management and the board of directors to receive information concerning elevated risk CSFTs in order to perform their oversight functions.

b. The Interagency Statement on CSFTs has shortened, narrowed and substantially revised the Proposed Interagency Statement on CSFTs in response to public comments, mainly from financial institutions and financial trade associations. Among the concerns raised by commenters with respect to the Proposed Interagency Statement on CSFTs were (i) the "prescriptiveness" of such Statement; (ii) the potential for vagueness to generate compliance obligations or even legal risk beyond the intended scope and purpose of such Statement, particularly with respect to CSFTs that have become "plain vanilla" after prolonged market exposure; and (iii) the need to distinguish among the roles that financial institutions play in CSFTs (ranging from financial adviser to arm's-length provider of services). In response, the Interagency Statement on CSFTs sets out principles-based guidance that imposes few concrete procedural or compliance obligations, but instead enunciates the goals that banks' internal policies should achieve. The specific focus on elevated risk CSFTs and recommendations with respect to differentiating them from more familiar, lower-risk CSFTs is part of this change in tone.

c. Comments on the Interagency Statement on CSFTs have supported revision of the Proposed Interagency Statement on CSFTs and have focused on:

(i) Clarifying the operational and compliance requirements the Interagency Statement on CSFTs imposes, and the obligations of boards of directors in particular.

(ii) Addressing key issues from an international bank's perspective, including those relating to (A) the manner in which a U.S. branch is required to harmonize its risk management procedures for elevated risk CSFTs with global risk management structures (i.e., whether a U.S. branch should be obligated to establish a control infrastructure that is additional to, rather than an integral part of, the bank's global control framework); (B) the scope of diligence required with respect to counterparty accounting, tax or legal issues; and (C) the level of required board of directors involvement.

(iii) Whether the Interagency Statement on CSFTs provides sufficient preemptive guidance, or implicates potential financial institution liability for aiding and abetting securities fraud.

3. Hypo-und Vereinsbank ("HVB") entered into a Deferred Prosecution Agreement, dated February 13, 2006, with the Department of Justice admitting that it had assisted in the evasion of taxes on $1.8 billion in income by (a) participating in and implementing fraudulent tax shelters through transactions purporting to be "loans" (but which were not bona fide loans); (b) participating in trading activity on instructions from promoters that was intended to create the appearance of investment activity but that had no real substance; and (c) participating in creating documentation that contained false representations concerning the purpose and design of the transactions. In addition to paying a $29 million fee, HVB agreed to (i) prohibit participating in any transaction or strategy that has a significant tax component, unless such transaction or strategy is accompanied by an opinion that the transaction "should" be upheld by the courts if litigated, and HVB independently concurs with that opinion; (ii) adopt a new "transaction approval" process for loan officers that involves review and approval by its Tax Director of any transaction that has a significant tax component; (iii) implement operational controls that will prevent account officers from controlling banking transactions

after the formal closing of the transactions; and (iv) implement and maintain an effective compliance and ethics program.[8]

4. A number of principles arise from the Interagency Statement on CSFTs and other recent developments.

a. Is it ethical?" is a critical starting point to any analysis of a CSFT. Furthermore, when analyzing a CSFT, it is important to think about how a disinterested observer would apply the relevant legal principles: "How would it look in The New York Times?" is a reasonable proxy for this test.

b. No bank or broker should (i) engage in any CSFT where it knows or believes that an objective of its counterparty is to achieve a misleading earnings, revenue or balance sheet effect; (ii) enter into any undocumented agreement; or (iii) use some perceived "market practice" -- the "everybody is doing it test" -- as a benchmark for compliance standards.

c. A financial intermediary needs to (i) establish a process for review and consideration of any unusual or suspect transaction where a purpose is to achieve a particular economic, accounting, tax, legal or regulatory objective (including an objective to obtain off-balance sheet treatment, to counteract or delay the failure of another transaction, to replace debt with funds characterized as other than debt, or to characterize as something other than a financing what is, in fact, a loan); and (ii) be attentive to CSFTs that could create legal or reputational risks (including CSFTs whose only purpose is to have a financial statement impact).

d. Although the Interagency Statement on CSFTs appears to move away from the implications in the Proposed Interagency Statement on CSFTs that a financial intermediary may need to be its "brother's keeper" in the context of CSFTs in a number of ways, it nonetheless remains the case that:

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8 See also Williams v. Sidley Austin Brown & Wood, Civ. Action No. 600808105 (Sup. Ct. N.Y. Co., September 22, 2006) (cause of action against law firm and its partner reinstated; HVB Deferred Prosecution Agreement shows that defendants participated in marketing and implementation of questionable tax shelters and were "more than just peripheral parties").

(i) It is not sufficient for a financial institution to assume that a counterparty will disclose and account for a CSFT properly, particularly if the CSFT has been structured in a way that could mask its economic effect and if the financial institution knows or has reason to believe that the CSFT could result in materially misleading financial statements.

In order to minimize this risk, a financial intermediary should ascertain how its counterparty intends to report a CSFT, and obtain appropriate assurance that the CSFT has a legitimate business purpose and that its counterparty will comply with applicable law insofar as the CSFT's legal, regulatory, tax, financial and accounting characterizations and disclosures are concerned.

(ii) Recording a CSFT in accordance with GAAP does not fully answer the question as to the propriety of the applicable disclosures.

(iii) Lawyers who advise on, or assist financial institutions in structuring, a CSFT may have an obligation to satisfy themselves as to the bona fides of the CSFT. The "mere scrivener" standard will not apply, nor will it satisfy appropriate standards simply to be a "slave to a checklist". Senior legal and compliance personnel (or senior management not involved in the implementation of the CSFT or supervision of the relevant business unit) should approve the structure of a CSFT. It will be important to focus on what a CSFT is trying to accomplish (with special attention to conflicts of interest) in evaluating its propriety.[9]

5. National Association of Securities Dealers ("NASD") Conduct Rules apply to the sale and trading of structured finance products, and the

[9] See generally, e.g., In re Ira Weiss, Securities and Exchange Commission ("SEC"), Admin. Proc. No. 3-11462 (December 2, 2005) (lawyer held liable for violating Section 17(a) antifraud provision of the Securities Act of 1933 for negligence in opinion issued to municipal securities issuer). See also note 8 above.

NASD has issued guidance to its members that they are obliged to (a) provide balanced disclosure in promotional efforts, (b) ascertain whether CSFTs are appropriate for the relevant accounts, (c) deal fairly with customers when making recommendations or accepting orders, (d) perform suitability determinations, (e) maintain a supervisory control system, and (f) implement adequate training. Failure to comply with these obligations, particularly when selling structured products to retail or comparatively unsophisticated investors, may result in NASD disciplinary action.[10]

C. Other Key Current Legal and Compliance Issues[11]

1. Responsibility for (a) building a "culture of compliance", (b) assuring compliance with "best" operational, ethical and business practices, and (c) implementing effective codes of conduct.[12]

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

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[10] NASD Notice to Members 05-59 (September 2005).

[11] This is not intended to be an exhaustive list of regulatory/supervisory and requirements, nor of all -- or even most -- laws, rules, regulations and other legal requirements applicable to the operation of international banks. Rather, it is intended to identify certain matters in the context of wholesale/institutional business (as compared with, e.g., retail, trust or similar business), that have been the subject of current regulatory concerns in different contexts.

This Outline is not intended, however, to address (i) all legal requirements applicable to the operation of a bank or broker-dealer (e.g., requirements with respect to broker-dealer registration as an investment adviser (and vice versa), books and records, account documentation, "free riding and withholding", "market-timing"/"late trading"/"analyst conflicts of interest", margin (or other) lending, business continuity planning, branch office supervision, custody/control, etc.); (ii) legal requirements which are not expected to be applicable until 2007 (e.g., SEC "broker push-out rules"); or (iii) 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.

[12] See, e.g., FDIC Financial Institution Letter FIL-105-2005 (October 21, 2005) (Corporate Codes of Conduct: Guidance on Implementing an Effective Ethics Program).

a. Participation in CSFTs, including those that may raise "appropriateness" or "suitability" considerations insofar as marketing to, or selection of, counterparties is concerned.

b. Transactions which raise conflict of interest concerns or where the likelihood of customer confusion is enhanced (e.g., sale of non-deposit investment products through a bank).

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

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

3. Focus on identification and resolution of conflicts of interest that arise (a) between the financial institution and its customers, (b) among the financial institution's customers, and (c) among different business units of the same financial institution. Conflicts of interest which arise from multiple relationships with a customer (e.g., lender, equity investor, advisor, board representative) may require special attention so that the potentially increased risk of equitable subordination, incurring fiduciary obligations, additional restrictions on information-sharing, etc., can be addressed.[13]

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[13] See, e.g., Financial Services Authority (the "FSA") Letter to Chief Executives, dated November 10, 2005, which sets out the FSA's view of the characteristics of a "well-managed firm" in respect of conflict of interest concerns, including the following:

(i) The firm has an up-to-date view of the totality of the types of conflicts of interest involved in its business activities.

(ii) The firm reviews on a regular basis the types of mitigation it considers acceptable to address conflict risks.

(iii) The firm has a conflict architecture that can deliver the mitigation resulting from the review process.

(iv) Senior management is involved in the process overall.

(fn. cont.)

4. Focus on compliance with restrictions on affiliate transactions.[14]

a. Although Sections 23A and 23B of the Federal Reserve Act[15] 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.

b. The FRB had previously imposed certain of the requirements of Sections 23A/23B on transactions between a U.S. branch of an international bank and its U.S. affiliates engaged in underwriting and dealing in bank-ineligible securities (12 C.F.R. § 225.200). In addition, Sections 23A/23B are applicable to transactions between (i) a U.S. branch of an international bank, on the one hand, and (ii) (A) affiliates of international bank FHCs which conduct activities pursuant to the GLBA merchant banking/insurance company investment authority, and (B) portfolio companies held under that authority, on the other (12 C.F.R. § 225.175).

(fn. cont.)

(v) Senior management is provided reports as to the extent and mitigation of conflicts of interest.

(vi) The culture of the firm supports effective management of conflicts of interest.

(vii) The conflict architecture results in a process that may be made subject to independent review.

14 See Bank Activities Guide at Part III.A.6.

15 12 U.S.C. §§ 371c, 371c-1 ("Sections 23A/23B").

c. Regulation W (12 C.F.R. § 223.61) applies Sections 23A/23B to cover transactions between a U.S. branch of an international bank and any affiliate of such bank directly engaged in the United States in the following covered activities: (i) non-credit-related insurance underwriting; (ii) full-scope securities underwriting, dealing and market-making; (iii) merchant banking; or (iv) insurance company investment activities.

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

(i) The nature, scope, pricing and disclosure of affiliate service and support agreements.

(ii) Satisfaction of the requirements for exemption from Section 23A of intraday extensions of credit by a bank to its affiliate (12 C.F.R. § 223.42(l)) that the bank (A) establish and maintain policies reasonably designed to manage the credit exposure arising from such credit extensions in a safe and sound manner (including policies for (1) monitoring and controlling the credit exposure from the bank's intraday extensions of credit to each affiliate and all affiliates in the aggregate, and (2) ensuring that any intraday extension of credit by the bank to an affiliate are on market terms; (B) has no reason to believe that the affiliate will have difficulty repaying the extension of credit in accordance with its terms; and (C) ceases to treat such extension of credit as an intraday extension of credit at the end of the bank's U.S. business day.

(iii) Satisfaction of the requirements for exemption from Section 23A of certain derivative transactions -- <u>other than</u> derivative transactions which are essentially equivalent to a loan -- by a bank with its affiliate (12 C.F.R. § 223.33) that the bank establish and maintain policies and procedures reasonably designed to manage the credit exposure rising from its derivative transactions with affiliates in a safe and sound manner, which, at a minimum, provide for (A) monitoring and controlling the credit exposure arising from such transactions with each affiliate and with all affiliates in the aggregate (including imposing appropriate <u>credit limits</u>, <u>mark-to-mark requirements</u> and <u>collateral</u>

requirements), and (B) ensuring that the bank's derivative transactions with affiliates are on market terms.

(iv) The application of the "attribution rule" (i.e., a transaction by a bank with any person is deemed to be a transaction with an affiliate "to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate").

(v) Expansive reading of the scope of "covered transactions" to include bank securities borrowing transactions from affiliates.[16]

(vi) 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 bank if an FHC that controls the bank owns or controls 15% or more of the equity capital of the portfolio company.

(vii) Bank support to funds advised by banking organizations or their affiliates (including through credit extension, cash infusion, asset purchases and acquisition of fund shares).

5. 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").[17]

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

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16 See FRB Letter to Bank of America, dated June 7, 2005.

17 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).

some additional product or service from the bank or one of its affiliates.

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

   a. U.S. federal banking authority being relied upon for such investment;[18] e.g.:

      (i) The FRB's merchant banking rules: FHC investments in "non-financial" companies.

      (ii) Treatment of merchant banking-type investments in financial services businesses (including such entities as banks/bank holding companies ("BHCs"), savings associations/thrift holding companies, international banks with U.S. operations, industrial banks, non-bank banks, 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, trust companies).[19]

      (iii) 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.

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18 See Bank Activities Guide at Part VII, Part VIII; 12 C.F.R. §§ 211.8 et seq., 211.23, 225.170 et seq.

19 See, e.g., FRB Letter re Franklin Resources, dated November 29, 2004; Board Letter to Capital Group Companies, dated August 13, 2002.

(iv) Issues with respect to investments in real estate and/or physical commodities.

(v) 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 25% 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.

(vi) 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.

(vii) BHCA § 4(c)(5): investments in small business investment companies.

b. Compliance with other applicable legal frameworks (e.g., Securities Exchange Act of 1934 (the "1934 Act"), Hart-Scott-Rodino Antitrust Improvements Act, legislation related to investments in regulated industries, state law requirements).

c. 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.).

7. Identification and monitoring of key risk indicators with respect to derivatives transactions and other trading activities,[20] including:

a. Addressing any legal risk that a derivative contract could be unenforceable if challenged.

b. Completion of "appropriateness" or "suitability" reviews of derivative clients.

[20] See Bank Activities Guide at Part II.

c. Providing ongoing training as to legal/compliance-related responsibilities in derivatives structuring, marketing and trading.

d. Assuring appropriate policies and procedures with respect to reporting and accounting, responsibility and authority, transaction processing, compliance-related supervision and reputational risk evaluation.

8. 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.[21]

9. Review/evaluation of outsourcing contracts. Appropriate due diligence, particularly of cross-border engagements, is increasingly important in respect of such matters as (a) security and confidentiality of bank and customer information, (b) monitoring of vendor performance and financial condition, (c) business continuity and disaster recovery, and (d) evaluation of "country risk" in terms of stability, applicability of foreign law and contract enforcement.[22]

10. Focus on compliance with banking and securities law requirements in connection with international securities transactions/linkages,[23] in terms of (a) licensing, and (b) supervision.

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[21] See Bank Activities Guide at Part V.A.3.d. See also, e.g., Statement of Principles for the Communication and Use of Confidential Information by Loan Market Participants (Loan Syndication and Trading Association, October 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).

[22] See, e.g., FDIC FIL-52-2006 (June 21, 2006) (Foreign-based Service Providers: Guidance on Managing Risks in These Outsourcing Relationships), which highlights the principal risks associated with such relationships, and describes recommended risk management steps (including due diligence, contractual protections, monitoring and oversight and access to information).

[23] See Bank Activities Guide at Part XI.D.

11. Focus on compliance with FRB international underwriting restrictions applicable to international banks which are not FHCs.

12. Focus on compliance with BSA/USA PATRIOT Act/OFAC anti-money laundering ("AML") requirements, including in respect of (a) SAR programs (tracking/monitoring/filing), (b) implementation of adequate customer identification/know-your-customer procedures, (c) trade finance, (d) foreign correspondent account review, and (e) diligence in respect of U.S. and non-U.S. shell companies and tax havens.[24]

    Key elements of SAR/AML programs identified in recent enforcement orders include the importance of a financial institution (i) understanding the normal/expected transactions of each customer; (ii) periodically reviewing a customer's account activity to update the parameters of "normal" activity if necessary; (iii) establishing a methodology to assign risk levels to different types of customers and products; (iv) providing enhanced due diligence for customers, products and geographic areas that pose higher risks; (v) establishing internal procedures for reporting information about potentially suspicious transactions; and (vi) engaging senior management in the process of identifying and reviewing significant SAR issues.

[24] See, e.g., Bush & Carroll, "Suspicious Activity Reporting: Recent Developments and Guidance on Key Issues", Review of Banking & Financial Services (November 2005). See also Bank Activities Guide at Part VIII.A.

13. Sensitivity to special concerns relating to broker-dealer/investment adviser and related compliance responsibilities.[25]

    a. 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.[26]

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[25] See e.g., Securities Industry Association Research Reports (August 31, 2005) (key aspects of a broker-dealer compliance function typically include (i) advisory roles (providing regulatory and compliance advice to business and control units on an ongoing basis); (ii) policies and procedures (assisting management in the development of policies, procedures and guidelines designed to facilitate compliance with applicable laws and regulations); (iii) education and training (keeping business personnel and other employees apprised of policies and procedures and regulatory events); (iv) monitoring and surveillance (critical ongoing monitoring of business activities, transactions and communications to identify potential issues, patterns of improper behavior or activities, material or systemic weaknesses and potential product-related problems); (v) business unit compliance reviews; (vi) centralized compliance functions (control-room function, administering information barriers within the firm, AML program, privacy, etc.); (vii) licensing, registration and employment-related functions (due diligence on new employees, advising on disciplinary issues, terminations, employee registration/licensing); (viii) internal inquiries and investigations (into potential violations of supervisory and regulatory restrictions); (ix) regulatory examinations, reporting and investigations; (x) fostering regulatory relationships, fostering a culture of compliance, assessment of compliance programs and functions; and (xi) chaperoning. See also North American Securities Administrators Association News Release, September 18, 2006 (best practices for broker-dealers and investment advisers).

See generally Bank Activities Guide at Part IX.E.

[26] See SEC Release No. 34-47364 (February 24, 2003); SEC Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules (September 2003). See also Bank Activities Guide at Part II.C and Part II.D.3.b.

b. Adoption and implementation of policies to guard against manipulative behavior, including in respect of government securities transactions.[27]

c. Top areas of interest for current SEC/NASD broker-dealer examinations include:[28]

(i) Maintenance of an appropriate "culture of compliance", including (A) oversight of compliance; (B) codes of conduct; (C), identification and control of compliance risks; (D) implementation of effective compliance and supervisory systems; (E) communication, education and training; (F) internal processes to monitor and audit the compliance system; (G) effective reporting and resolution of significant compliance issues; and (H) policies to enforce and maintain compliance policies to respond to violations and sanction non-compliant actions.

(ii) Whether supervisory procedures and compliance programs are appropriately tailored to the broker-dealer's business.

(iii) Conflicts of interest, including (A) disclosure-related issues (e.g., payments by mutual funds to broker-dealers and the use of soft dollars); (B) allocation of

27 See, e.g., Remarks of Department of the Treasury Deputy Assistant Secretary for Federal Finance James Clouse, September 27, 2006 (perceived increase in trading practices in cash, repo and futures markets for U.S. Treasury securities that have raised questions as to whether firms have sought to gain a significant degree of control over Treasury issues and used that market power to their advantage, distorting prices in the cash, repo and futures markets).

28 See, e.g., Remarks of SEC Office of Compliance Inspections and Examinations Director Richards, October 19, 2006; Remarks of SEC Commissioner Nazareth, September 13, 2006; Remarks of SEC Office of Compliance Inspections and Examinations Associate Director Gadziala, May 16, 2006, October 19, 2005; Remarks of Associate Director of SEC Office of Compliance Inspections and Examinations Walsh, April 18, 2006; Remarks of SEC Office of Compliance Inspection and Examinations Associate Director Gohlke, November 14, 2005. See also NASD, 2005 in Review (December 27, 2005).

limited products, services or opportunities to favored clients or provision of special incentives or payments for use of products or services; (C) use of products or services of affiliates or favored clients; (D) playing multiple roles in a transaction or with respect to an issuer or client; (E) biased research and advice; (F) accounting, booking or reporting to achieve other interests; and (G) gifts and entertainment to and from clients.

(iv) Trading and pricing practices; e.g., insider trading issues, front-running, misuse of customer trading data or other non-public information, and best execution responsibilities (including in the context of "bundled" commissions).

(v) Sales practices (including suitability, disclosure of risks, costs and fees, unauthorized trading, churning, switching and misrepresentation of performance results), with special emphasis on fee-based accounts, sales and marketing to senior citizens, separately managed accounts, variable annuities, penny stocks, private placements, illiquid securities, volatile securities and hedge funds.

(vi) Supervision and compliance (including capital compliance and compliance with AML requirements), with a focus on branch offices, independent contractors, and comprehensive and effective coverage of all business areas.

(vii) Creating and marketing structured finance products.

(viii) Internal controls (including risk management and separation of banking from research), reporting, books and records and e-mail retention.

(ix) Procedures to prevent misappropriation of customer assets.

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

(xi) Information security

(xii) Business continuity practices.

(xiii) How the broker-dealer identifies and responds to “red flags” given the nature of its business.

(xiv) Nature and scope of cooperation with regulatory inquiries.

d. With respect to investment advisers/investment companies, recent areas of compliance interest include:[29]

(i) Disclosure (including in respect of client risks, directed brokerage arrangements, fees, “mixed use arrangements” involving “soft dollar” and administration fees, and conflicts of interest).

(ii) Portfolio management controls to ensure client investments are consistent with client mandates, risk tolerance and goals.

(iii) Personal trading issues (including codes of ethics and controls).

(iv) Performance calculations.

(v) Satisfaction of best execution responsibilities.

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

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

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[29] See, e.g., Remarks of SEC Office of Compliance Inspections and Examinations Associate Director Gohlke, October 19, 2006; Remarks of SEC Associate Director Walsh, April 18, 2006; Remarks of SEC Director Richards, February 27, 2006; Remarks of SEC Director Roye, January 28, 2005.

(viii) Policies and disclosures with respect to trade allocations among clients.

(ix) Side-by-side management of hedge funds.

(x) Disclosure of portfolio holdings (including conflict of interest issues).

(xi) Advertising and performance claims.

(xii) Use of brokers (e.g., soft dollar payments, non-research or mixed-use products, distribution, directed brokerage, client referrals, etc.).

(xiii) Fair value pricing and net asset value calculations.

(xiv) Fees (including performance, administrative and soft-dollar fees and fund confirmation and point of sale fee disclosure).

(xv) Book and record maintenance (including reconciliation of custodian/fund/adviser records).

(xvi) Information security.

(xvii) Proxy voting for clients (including documenting procedures and appropriate disclosure)

(xviii) Custody of client assets (including securities lending and delivery of account statements).

e. NASAA News Release, September 13, 2005, recommended best practices for investment advisers to improve their compliance practices and procedures, including (i) reviewing and revising Form ADV/disclosure brochure to reflect current and accurate information, (ii) reviewing and updating advisory contracts, (iii) maintaining a written supervisory procedures manual, (iv) preparing and regularly distributing a privacy policy, (v) accurate recordkeeping, (vi) maintaining any required surety bond, (vii) preparing and maintaining client profiles, (viii) calculating and documenting fees correctly, (ix) reviewing and revising advertisements, and (x) implementing custody safeguards.

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