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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

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Operational Risk Management and Related Issues 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, among other things (i) internal fraud (an intentional act intended to defraud, misappropriate property or circumvent the law or bank policy); (ii) external fraud; (iii) employment practices; (iv) clients, products and business practices (an unintentional or negligent failure to meet a

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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, 2009.

[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 (Thomson LegalWorks, 13th ed., 2008) (the "Bank Activities Guide") at Part II.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 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. Regulators have also 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.

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 compliance failures are perceived as the biggest source of reputational risk.

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 II 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.[3]

a. From the perspective of FBOs, 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))(the "2008 Compliance Guidance") reflects the determination that, in recent years, FBOs have greatly expanded the scope, complexity and global nature of their business activities, and compliance requirements associated with these activities have become more complex. As a result, FBOs have confronted significant risk management and corporate governance challenges, particularly with respect to compliance risks that transcend business lines, legal entities and jurisdictions of operation.

(i) The 2008 Compliance Guidance states that, while the guiding principles of sound risk management are the same for compliance as for other types of risk, the management and oversight of Compliance Risk presents certain challenges, and that Compliance Risk does not lend itself to traditional processes for establishing and allocating overall risk tolerance. In addition, Compliance Risk metrics are often less meaningful in terms of aggregation and trend analysis as compared with more traditional Market and Credit Risk metrics.

(ii) In particular, the 2008 Compliance Guidance clarifies that:

A) 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

[3] See also, e.g., Financial Regulation: Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions (GAO, Mar. 18, 2009); Remarks of FRB Governor Olson, June 12, 2006 (What Are Examiners looking for When They Examine Banks for Compliance?).

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.

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

(i) 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 also have a reporting line to the corporate function with compliance responsibilities.

(ii) In addition, an FBO that chooses to implement a dual reporting structure should ensure that (A) 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); (B) compensation and incentive programs should be carefully structured to avoid undermining the independence of compliance staff (i.e. not on the basis of the financial performance of the business line); and (C) appropriate controls and enhanced corporate oversight should identify and address issues that may arise from conflicts of interest affecting compliance staff within the business lines.

C) Robust compliance monitoring and testing play a key role in identifying weaknesses in existing Compliance Risk management controls and are, therefore, critical components of an effective risk management program.

D) While the primary responsibility for complying with applicable rules and standards must rest with the individuals within the organization as they conduct their day-to-day business and support activities, the board of directors, senior management and the corporate compliance function are responsible for working together to establish and implement a comprehensive and effective risk management program and oversight framework that is reasonably designed to prevent and detect compliance breaches and issues.

b. Consolidated Supervision of [BHCs] and the Combined U.S. Operations of [FBO's] (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.

(i) The FRB's systemic approach to assess the combined U.S. operations of an FBO are reflected in the FBO's combined U.S. operations rating.

(ii) The FRB's key FBO supervisory objectives are to (A) understand key elements of the FBO's strategy, primary revenue sources and activities, risk drivers, business lines, legal entity/regulatory structure, corporate governance and internal control framework, and presence in key financial markets; and (B) assess (1) the effectiveness of risk management systems and controls over the primary risks inherent in the FBO's activities; (2) the FBO's financial condition; and (3) the potential negative impact of non-bank operations on the FBO's affiliated depository institutions.

(iii) Primary areas of focus for an FBO will include:

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

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

(C) Where applicable, core clearing and settlement activities and related risk management and internal controls of firms that are large-value payment system operators and market utilities.

(D) For large, complex FBOs, activities in key financial markets in which the FBO plays a significant role, as well as related risk management and internal controls.

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

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

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

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

2. <u>"Home Country" v. "Host Country" Supervisory Focus/Licensing Issues</u>

a. Examination issues have arisen as to the appropriate role of a "<u>host country</u>" 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>U.S. subsidiaries</u> (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 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.

(iii) In short, the FRB's program for large international banking organizations generally includes (A) continuous monitoring and assessment of U.S. operations, (B) review of country and institutional information received outside of the on-site examination process, (C) communications with home country supervisors, and (D) assignment to each large banking organization of a full time supervisory team and staff.

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) In July 2009, the Basel Committee on Banking Supervision ("Basel") released Enhancements to the Basel II Framework to strengthen Basel II in light of weaknesses revealed by the 2007-2009 financial crisis. Modifications to (A) Pillar I include tightening the regulatory capital treatment of those exposures and activities which performed adversely or posed heightened risks during the financial market stress; (B) Pillar II include more rigorous supervision of risk management, off-balance sheet exposures, securitizations and related reputational risks; and (C) Pillar III include increasing disclosure related to securitization positions and capital charges.[4]

(iii) The role of a leverage ratio in capital planning has received renewed international attention.

d. Potential areas of focus in implementing Operational Risk standards for an international banking operation involve

[4] See also, 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) (recommends that regulators assess the extent to which Basel's enhancements adequately address risks posed to the system by leveraging and deleveraging); Assessment of Banks' Pillar 3 Disclosures (Committee of European Banking Supervisors ("CEBS"), June 24, 2009); Findings on the Interaction of Market and Credit Risk (Basel, May 2009); Basel II's Proposed Enhancements - Focus on Concentration Risk (Fitch, April 16, 2009); Range of Practices on Some Basel II Implementation Issues (CEBS, August 12, 2008).

(i) home-host supervisory cooperation, and (ii) the bifurcated application of Basel II in 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 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). Thus, the sum of individual legal-entity capital requirements may be greater than consolidated-entity requirements.

(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. Major issues confronting U.S. and international policymakers as they work toward an effective and integrated supervisory regime include:

(i) A focus on cross-border resolution/coordination mechanisms.

(ii) The role of accounting standards in shaping financial regulation.

(iii) A stronger emphasis on the development of forward-looking safety and soundness compliance.

(iv) Regulation and reporting of executive compensation, and compensation arrangements for highly-paid employees more generally.

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

g. 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 "NYBD") has advised informally that a U.S. broker-dealer subsidiary of an FBO need not 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.

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

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[5] See, e.g., Compendium of Supplementary Guidelines on Implementation Issues of Operational Risk (CEBS, September 2009); Results From the 2008 Loss Data Collection Exercise for Operational Risk (Basel, July 2009); Observed Range of Practice in Key Elements of the Advanced Measurement Approach (Basel, July 2009); "Operational Risk Under Basel II: A Model for Extreme Risk Evaluation", Banking & Fin. Serv. Policy Rept. (October 2008).

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. 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"[6] (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. Policies to identify, measure, assess, monitor, test and minimize Compliance/Legal/Reputational Risk, backed by a well-resourced, independent compliance staff.

d. Policies governing the accumulation, retention, use and dissemination of data, including customer data.

e. 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.).

[6] See generally Implementation of the Compliance Principles: A Survey (Basel, August 2008).

f. Procedures for prompt redress of reporting problems.

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

h. Close integration of the governance, risk management and compliance functions.

i. Limitations on outsourcing the compliance function.

j. 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.

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 are neglected.

e. Reputational Risk issues are not given serious attention.

B. Bank Trading Activities and the Market Crisis[7]

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

[7] See generally Deloitte 2009 Global Risk Management Survey: Risk Management in the Spotlight; Proposed Interagency Guidance - Funding and Liquidity Risk Management, 74 Fed. Reg. 32035 (July 6, 2009), as corrected by 74 Fed. Reg. 40867 (August 13, 2009); Follow-Up Review of Banks' Transparency in Their 2008 Audited Reports (CEBS, June 24, 2009); Comptroller of the Currency Bulletin 2009-15 (May 22, 2009) (Investment Securities: Risk Management and Lessons Learned); Integrated Compliance and Risk Management: Rethinking the Approach (Deloitte, 2008); Risk Management in the Age of Structured Products: Lessons Learned for Improving Risk Intelligence (Deloitte, 2008); Progress Update on March Policy Statement on Financial Market Developments (President's Working Group on Financial Markets ("PWG"), October 2008); Global Financial Stability Report: Financial Stress and Delinquency -- Macrofinancial Implications and Policy (International Monetary Fund, October 2008); Final Report of the [Institute of International Finance] Committee on the Market Best Practices: Principles of Conduct and Best Practice Recommendations -- Financial Services Industry Response to the Market Turmoil of 2007-2008 (CEBS, July 2008); Report on Banks' Transparency on Activities and Products Affected by the Recent Market Turmoil (CEBS, June 18, 2008); Guidelines for Foreign Exchange Trading Activities (Federal Reserve Bank of New York, May 2008); The Financial Turmoil of 2007-?: A Preliminary Assessment and Some Policy Considerations (Bank of International Settlements Working Paper, March 2008); Policy Statement on Financial Market Developments (PWG, March 2008).

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) minimizing conflicts of interest in the credit rating process by differentiating ratings used for structured products from those for corporate bonds and reducing investor reliance on credit ratings; (d) strengthening regulators' responsiveness to excessive risk concentrations through improved internal and cross-border information exchanges and a continued emphasis on policy development; and (e) 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.[8] 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.

[8] See generally Unauthorized Proprietary Trading: Sound Practices for Preventing and Detecting Unauthorized Proprietary Trading (Financial Industry Regulatory Authority ("FINRA") Regulatory Notice 08-18 (April 2008)).

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. These programs frequently exhibit:

a. Coordination between the compliance and ethics specialists and individual business units.

b. Consistent implementation of the program throughout the organization's business lines.

c. Clear and effective division of roles and responsibilities among the ethics office, compliance, legal and other relevant units.

d. Periodic evaluation by the board of directors and management of the effectiveness and design of the program.

III. Other Key Current Legal and Regulatory Issues[9]

A. Responsibility for (1) building a "culture of compliance", (2) assuring compliance with "best" operational, ethical and business practices, and (3) implementing effective codes of conduct.

B. 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.[10]

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[9] 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 current 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.

[10] 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).

fn cont.

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).

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.

C. 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.

(fn. cont.)

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

D. 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.[11]

E. Focus on compliance with restrictions on affiliate transactions.[12]

1. Although Sections 23A and 23B of the Federal Reserve Act[13] 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.

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11 See, e.g., Confidential Information Supplement to Loan Syndications and Trading Association [("LSTA")] Code of Conduct (October 2008) (describing (i) types of information in the loan market; (ii) the circumstances under which a market participant may trade on such information; (iii) pre-transaction due diligence recommendations; and (iv) internal procedure recommendations (such as information barriers and trading restrictions) to ensure that the market participant follows high standards of professional integrity, fair dealing and legal requirements), 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.

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

13 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. Satisfaction of the requirements for exemption from Section 23A of certain derivative transactions -- other than derivative transactions which are essentially equivalent to a loan -- by a Covered Branch with its Covered Affiliate (12 C.F.R. § 223.33) that the Branch establish and maintain policies and procedures reasonably designed to manage the credit exposure rising from its derivative transactions with such Affiliates in a safe and sound manner; at a minimum, these policies and procedures should provide for (i) monitoring and controlling the credit exposure arising from such transactions with each such Affiliate and with all such Affiliates in the aggregate (including imposing appropriate credit limits, mark-to-mark requirements and collateral requirements); and (ii) ensuring that the Branch's derivative transactions with such Affiliates are on market terms.

d. 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").

e. Expansive reading of the scope of "covered transactions" to include a Covered Branch's securities borrowing transactions from Covered Affiliates.

f. 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.

g. 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).

F. 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").[14]

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.

G. 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:

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[14] 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); Municipal Securities Rulemaking Board Notice 2008-34 (August 14, 2008) (Notice on Bank Tying Arrangements, Underpricing of Credit and Rule G-17 on Fair Dealing).

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

1. U.S. federal banking authority being relied upon for such investment;[15] 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.[16]

   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".

   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

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[15] 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.

[16] See 12 C.F.R. § 225.144 (FRB Policy Statement on Equity Investments in Banks and [BHCs]).

portfolio company ("4(c)(6) Investments"), or investments in an "investment company" limited to investments in debt "securities" and/or 4(c)(6) Investments.

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 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".[17]

(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 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.).

[17] 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).

H. Identification and monitoring of key risk indicators with respect to derivative transactions and trading activities. 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 (e.g., 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 outsourcing or offshoring contracts. 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.

J. Focus on compliance with banking and securities law licensing/supervisory requirements in connection with international securities transactions/linkages.[19]

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

[19] See SEC Release No. 34-58047 (June 27, 2008) (proposed amendments to SEC Rule 15a-6).

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

fn cont.

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

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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 Release, August 19, 2009 (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); Investigation of the Cross-Border Business of UBS A.G. with Private Clients in the United States (Swiss Financial Markets Supervisory Authority, February 18, 2009); IRS Announcement 2008-98 (November 3, 2008) (proposing amendments to the IRS Qualified Intermediary Program that would require foreign financial institutions that act as qualified intermediaries to provide the IRS early notification of material failure of internal controls, to improve evaluation of risk of circumvention of U.S. taxation by U.S. persons, and to include audit oversight by a U.S. auditor).

In addition, in CentreInvest, SEC Admin. Proc. No. 3-13304 (December 8, 2008), the SEC charged a Moscow-based unregistered broker-dealer and an associated individual with soliciting institutional investors in the United States without registering as a broker-dealer or complying with an exemption from registration. It also charged the New York affiliate of the Moscow broker-dealer and associated individuals with aiding and abetting the Moscow affiliate's violation of the broker-dealer registration requirements and with recordkeeping violations.

See generally Bank Activities Guide at Part XI.

trading by hedge funds, particularly with respect to "private investment in public equity" (PIPE) transactions; and (6) "retailization" of hedge fund clients.[20]

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.[21]

M. Focus on compliance with BSA/USA PATRIOT Act/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.[22]

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[20] See, e.g., Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices (International Organization of Securities Commissions ("IOSCO"), September 2009); Hedge Funds Oversight: Final Report (IOSCO, June 22, 2009); Remarks by SEC Commissioner Aguilar, June 18, 2009 (Hedge Fund Regulation on the Horizon: Don't Shoot the Messenger); Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges (GAO, May 7, 2009); Best Practices for the Hedge Fund Industry – Report of the Asset Managers' Committee to the [PWG] (January 15, 2009); Principles and Best Practices for Hedge Fund Investors – Report of the Investors' Committee to the [PWG] (January 15, 2009); Hedge Fund Reporting Survey (EDHEC Risk and Asset Management Research Centre, November 2008); Leading-Practice Disclosures for Selected Exposures (Senior Supervisors Group, April 11, 2008).

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

[21] 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).

[22] See Interagency BSA Examination Manual; Risk Factors for OFAC Compliance in the Securities Industry (Department of the Treasury); The SAR Activity Review: Trends, Tips & Issues (Financial Crimes Enforcement Network ("FinCEN"),

fn cont.

1. Significant enforcement actions continue against financial institutions for BSA, OFAC and related violations. Most of the major enforcement actions have involved failure to detect and report suspicious activity, which is then treated as an indication of failure to maintain an effective AML 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; and (i) concealing information from examiners.

2. 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 SAR/AML 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 SAR 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

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October 2009) (including "Law Enforcement Suggestions When Preparing [SARs]" and "Avoiding Common Errors in [SARs]"). Compare Compendium Paper on the Supervisory Implementation Practices Across EU Member States of the Third Money Laundering Directive (CEBS, October 15, 2009).

See generally Bank Activities Guide at Part VIII.A.

regulatory criticism and to issues identified by independent testing; and (m) complying with SAR confidentiality requirements.[23]

3. 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;[24] (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.

4. OFAC Economic Sanctions Enforcement Guidelines (73 Fed. Reg. 51933 (September 8, 2008))[25] 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.

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23 See 74 Fed. Reg. 10130 et seq. (March 9, 2009) (proposed rules to permit the sharing of SARS within an institution's corporate structure); IIB Comment Letter, dated June 8, 2009. See also FIN-2009-G002 (FinCEN, June 16, 2009) (Guidance on the Scope of Permissible Information Sharing Covered by Section 314(b) Safe Harbor of the [PATRIOT Act]); Interagency Guidance on Sharing [SARs] with Head Offices and Controlling Companies (January 20, 2006).

24 See e.g., Lloyds TSB Bank Deferred Prosecution Agreement (January 9, 2009) ($350 million penalty for allegedly removing information from payment messages so that wire transfers would pass undetected through filters at U.S. financial institutions; first enforcement action against a non-U.S. financial institution for causing OFAC violations in the United States by a non-affiliated U.S. financial institution).

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

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

5. 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.

(i) A key issue is the use of "cover payments" (MT202s) that are used to clear U.S. dollar transfers and do not disclose their origin or beneficiary.

(ii) SWIFT has adopted a new cover payment message (MT 202COV) that will be implemented beginning in November 2009 and will provide greater transparency. Basel issued guidance for due diligence standards

regarding this new message format,[26] and OFAC has also issued guidance which provides potential relief to intermediary banks from diligencing non-account parties.[27]

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).

6. 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").[28]

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.

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

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[26] Due Diligence and Transparency Regarding Cover Payment Messages Related to Cross-Border Wire Transfers (Basel, May 2009).

[27] Frequently Asked Questions (OFAC, February 24, 2009).

[28] 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.

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 written laws and regulations" of the relevant county and certain other defined "reasonable and bona fide 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 (the "FINRA 2009 Letter"), which, for the first time, included FCPA compliance in its broker-dealer examination priorities -- make clear that financial services firms will be the subject of FCPA-related scrutiny.

4. 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.

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 contingency planning, backup, and recovery programs.

P. Focus on information security, particularly in light of increased instances of identity theft.[29]

Q. 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".[30]

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

30 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.

2. Compliance with the SEC's "Broker Push-out Rules" as reflected in Regulation R.[31]

3. Top areas of interest for current SEC/FINRA broker-dealer examinations include:[32]

   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. Risk management, supervisory and compliance procedures and internal controls, including those related to (i) internal audit; (ii) adequacy of resources and systems used for risk management; (iii) Market, Funding, Liquidity, Credit and Operational Risks; (iv) legal and compliance controls; (v) supervisory procedures; (vi) FCPA compliance; (vii) assimilation of new products (including structured finance products) and activities into risk management and approval systems; (viii) separation of banking from research; (ix) disclosure (including performance advertising and marketing); (x) reporting (including data integrity); (xi) books/records/email retention; and (xii) and inventory and collateral valuations (including of structured products, especially "sub-prime" mortgage-related products).

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[31] See 12 C.F.R. Part 218.

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

[32] See, e.g., FINRA 2009 Letter, Remarks of SEC Director Richards, June 17, 2009, October 21, 2008, Remarks of SEC Chairman Shapiro, April 6, 2009 (collectively, the "SEC Examination Guidance").

See generally Bank Activities Guide at Part IX.E.

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 (e.g., front-running); (iii) allocation of limited products, services or opportunities to favored clients or 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 fee-based accounts, sales and marketing to senior citizens, separately managed accounts, variable annuities, "Section 529" college savings plans, penny stocks, private placements, 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 intentionally spreading false information.

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

h. Policies and procedures for the safeguarding of customer assets from theft, loss, misuse and misappropriation, including by reviewing existing custodial and prime brokerage arrangements.

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

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

k. Business continuity programs.

l. Nature and scope of cooperation with regulatory inquiries.

m. Bank sweep programs.

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

o. 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).

p. Custodial risk issues (including unannounced audits and other supervisory examinations of custodians), particularly as they relate to firms which "self-custody" client assets.

4. With respect to investment advisers/investment companies, recent areas of compliance interest include:[33]

[33] See, e.g., SEC Examination Guidance; North American Securities Administrators Association News Release, September 29, 2009 (Best Practices for Investment Advisers); Compliance Review for Fund Intermediaries (Investment Company Institute, November 6, 2008).

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

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)).[34]

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

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

e. Brokerage arrangements and satisfaction of best execution responsibilities.

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

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

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

i. Advertising/marketing and performance claims.

j. Fair value pricing and valuation controls.

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

l. Information processing and protection.

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

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[34] See SEC Release No. IA-2910 (August 7, 2009) (solicitation of public comments).

n. Custody/safety of client/fund assets (including securities lending and delivery of account statements).[35]

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.

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[35] See SEC Release No. IA-2876 (May 20, 2009) (proposed amendments to Rule 206(4)-2, which regulates the custodial practices of registered investment advisers).

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