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INSTITUTE OF INTERNATIONAL BANKERS

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

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

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

New York
October 22, 2008

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 The author is grateful for the assistance of Timothy Byrne, Senior Attorney at Cleary Gottlieb, for his assistance in the preparation of this memorandum.

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

I. Introduction

Operational risk 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

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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 16, 2008.

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, 12th ed., 2007) (the "Bank Activities Guide") at Part II.A.

practices (an unintentional or negligent failure to meet a professional obligation (including fiduciary and suitability requirements)); (v) damage to physical assets; (vi) business disruption and system failures; or (vii) failed execution, delivery and process management.

b. Operational Risk is a broader concept than "operations" or back office risk. It encompasses risk inherent in business activities across a financial institution -- including 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. 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. 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

On October 16, 2008, the Federal Reserve Board (the "FRB") 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 released guidance clarifying supervisory expectations with respect to firmwide compliance risk management.

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 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. "Home Country" v. "Host Country" Supervisory Focus[3]

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

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.

[3] See generally Principles for Home-Host Supervisory Cooperation and Allocation Mechanisms in the Context of the Advanced Measurement Approach [for Operational Risks] (Basel Committee on Banking Supervision ("Basel"), November 2007).

(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. Potential areas of difficulty in implementing Operational Risk standards for an international banking operation involve (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 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 in the Operational Risk context 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.

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

A. General Approach

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.

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" (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.).

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

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.[4] Among the relevant key developments:

[4] See, e.g., Liquidity Risk Management, Federal Deposit Insurance Corporation FIL-84-2008 (August 26, 2008); Principles for Sound Liquidity Risk Management and Supervision (Basel Consultation Draft, June 2008); Federal Reserve Bank of New York ("FRBNY") Guidelines for Foreign Exchange Trading Activities (May 2008); Credit Risk Transfer (Joint Forum, April 2008); Cross-Sectoral Review of Group-

(fn. cont.)

a. In 2008, Société Générale ("SocGen") announced a loss of €4.9 billion on equity positions linked to fraudulent activity by one of its traders, Jerome Kerviel. The trader allegedly took unauthorized directional positions on European stock futures, offset by fictitious transactions that masked the size of the position and SocGen's net exposures. The trader appears to have been especially well positioned to carry out unauthorized transactions because he had previously worked in the middle office units responsible for risk monitoring and, therefore, had an understanding of control procedures.

(i) SocGen established a Special Committee of its board of directors to identify the control malfunctions that allowed Kerviel to conceal his trading losses. The Report of the Board of Directors to the General Shareholders Meeting (May 25, 2008) (including PricewaterhouseCoopers Summary of Diagnostic Review and Analysis of the Action Plan (May 23, 2008)), General Inspection Department Mission Green Summary Report (May 20, 2008), and Progress Report of the Special Committee of the Board of Directors (February 20, 2008), highlighted 5 principal reasons that SocGen failed to detect the unauthorized trading: (A) ineffective supervision, (B) insufficient senior management support to Kerviel's manager, (C) insufficient attention to front office alerts, (D) an overly tolerant managerial attitude towards intraday trading, and (E) a chaotic operations environment.

(fn. cont.)

Wide Identification and Management of Risk Concentrations (Joint Forum, April 2008); Actions to Enhance Market and Institutional Resilience (Financial Stability Forum, April 11, 2008); Liquidity Risk; Management and Supervisory Challenges (Basel, February, 2008); Deloitte 2007 Global Risk Management Survey: Accelerating Risk Management Practices; Trends in Risk Integration and Aggregation (Joint Forum, August 2003); "Governing the [FHC] or [BHC]: How Legal Infrastructure Can Facilitate Consolidated Risk Management", FRBNY Current Issues (March 2003).

b. French Economy, Finance and Employment Minister Lagarde presented a Report to the Prime Minister on Lessons to be Learned from Recent Events at [SocGen] (February 4, 2008). The Report highlighted control points that should be examined by financial institutions to reduce the risk of "rogue" trading, including:

(i) Heightened monitoring of gross notional amounts of exposures held by the institution.

(ii) Maintenance of an audit trail for each trading transaction.

(iii) Recordation and analysis of anomalies and errors in the handling of transactions.

(iv) Prompt confirmation of trades through effective reconciliation procedures.

(v) Detailed documentation of transaction terms and conditions.

c. In the aftermath of the SocGen incident and similar episodes -- typically involving trading exposures and unusual market positions that exceeded internal limits or otherwise raised risk management, legal or compliance issues -- 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.

(i) Unauthorized Proprietary Trading; Sound Practices for Preventing and Detecting Unauthorized Proprietary Trading (Financial Industry Regulatory Authority ("FINRA") Regulatory Notice 08-18, April 2008) lists practices to assist financial firms in establishing effective internal controls and risk management systems. This list includes:

A) Mandatory vacation policies for employees in sensitive positions.

B) Heightened scrutiny of (1) trading limit breaches; (2) unrealized profit-and-loss

("P&L") on unsettled transactions; (3) unusual patterns of cancellations and corrections; (4) transactions in which confirmation and settlement do not occur on a timely basis; (5) reports of aged unresolved reconciling items and aged outstanding confirmations; (6) P&L reports that exceed an expected amount; (7) details underlying a trader's value-at-risk; (8) repeated requests by a trader to relax position or P&L limits or other internal controls; (9) trading in products outside of a trader's expertise; (10) unusual differences between a trader's account positions and account activity; and (11) a pattern of aged fails to deliver.

C) Limitations on employee access to systems where such access is not required and implementation of heightened systems security measures.

D) Documented, effective allocation of supervisory roles and responsibilities.

E) Regular reconciliation of intercompany transactions and implementation of controls for affiliated transactions.

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

(ii) 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.

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.[5]

(i) 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

[5] See, e.g., Policy Statement on Financial Market Developments (President's Working Group ("PWG"), March 2008); Progress Update on March Policy Statement on Financial Market Developments (PWG, October 2008); Global Financial Stability Report: Financial Stress and Delinquency -- Macrofinancial Implications and Policy (International Monetary Fund, October 2008).

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 liquidity support from central bank facilities.[6]

(ii) Observations on Risk Management Practices During the Recent Market Turbulence (March 6, 2008) reflects a Survey by senior financial supervisors from France, Germany, Switzerland, the U.K. and the U.S. (the "Senior Supervisors Group") of risk management practices among global financial institutions in the context of market disruptions. The Survey centered on (A) the role of senior management oversight in assessing risk; (B) the effectiveness of Market/Credit Risk management practices in understanding counterparty exposures and valuing complex/illiquid products; and (C) the effectiveness of Liquidity Risk management.

A) The Senior Supervisors Group sought to identify examples of risk management practices that have tended to be associated with better or

[6] See, e.g., Containing Systemic Risk: The Road to Reform (Counterparty Risk Management Policy Group, August 6, 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 (Conference of European Bank Supervisors ("CEBS"), July 2008); Report on Banks' Transparency on Activities and Products Affected by the Recent Market Turmoil (CEBS, June 18, 2008); Report on Issues Regarding the Valuation of Complex and Illiquid Financial Instruments (CEBS, June 18, 2008); Remarks of Federal Reserve Bank of Boston President Rosengren, May 14, 2008 (Risk Management Lessons from Recent Financial Turmoil); The Financial Turmoil of 2007-?; A Preliminary Assessment and Some Policy Considerations (Bank for International Settlements Working Paper, March 2008); Policy Statement on Financial Market Developments (PWG, March 2008). See also note 5 above.

weaker performance during the current market turmoil.

B) According to the Senior Supervisors Group, hallmarks of the risk management practices of the better performing firms include:

(i) Active oversight by members of senior management: The timing and quality of information provided to senior management varied widely. For example, in some cases, hierarchical structures tended to delay or lead to the distortion of information sent up the management chain. In contrast, the more successful firms effectively eliminated Senior Supervisor's "organizational layers" as events unfolded to provide senior managers with more direct means of communication and enhanced senior management understanding of emerging issues, as well as management's ability to act on that understanding to mitigate excessive risks. Such firms were more likely to detect and address inappropriate practices and weaknesses at an earlier stage.

(ii) A comprehensive approach to viewing firm-wide exposures and risk sharing: Existence of "silos" (segregated/ independent operational units) in the structures of some firms appeared to have an adverse impact on performance during the turmoil. At institutions that avoided significant losses, risk management had independence and authority but also considerable direct interaction with senior business managers. Senior managers at firms that experienced more significant unexpected losses frequently accepted a

more segregated approach to internal communications about risk management.

3. Identification and monitoring of key risk indicators with respect to derivatives transactions and other trading activities is a key operational responsibility, including:

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

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

   c. 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 ("FERC") 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).[7]

   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]

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[7] See Schotland, Tortoriello and Bidstrup, "FERC Regulation of Banks Proposing to Qualify as Power Marketers", BNA's Banking Report (September 17, 2007).

[8] Recent Securities and Exchange Commission ("SEC") and state administrative actions respecting the sale of auction rate securities underscore the necessity of a continuing focus on assuring that risks of trader participation in bid rigging, securities registration violations and deceptive marketing and sales practices are fully addressed. See, e.g., Merrill Lynch, SEC Release 2008-181 (August 22, 2008); North American Securities Administrators Association ("NASAA") Releases, August 22, 21, 15, 14, 11, 7, 2008 (settlements with Citigroup, Deutsche Bank, Goldman Sachs, JP Morgan Chase, Merrill Lynch, Morgan Stanley, UBS and Wachovia).

C. Other Key Current Legal and Compliance Issues[9]

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.[10]

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

a. Participation in complex structured finance transactions ("CSFTs") driven by accounting, tax, regulatory or other avoidance motivations, or novel, complex or unusually profitable transactions that may raise "appropriateness" or

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[9] This is not intended to be an exhaustive list of regulatory/supervisory 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.); or (ii) 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 from an Operational Risk perspective.

[10] See generally 2008 Compliance Guidance; Implementation of Compliance Principles: A Survey (Basel, August 2008); Compliance and the Compliance Function in Banking (Basel, April 2005); Navigating the Compliance Labyrinth: The Challenge for Banks (Deloitte, 2007).

"suitability" considerations insofar as marketing to, or selection of, counterparties is concerned.[11]

In this regard, a financial intermediary should (i) establish policies, and 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 not 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) be attentive to CSFTs that could create legal or reputational risks; (iii) conduct its review and diligence process in respect of elevated risk CSFTs through well-qualified accounting, legal, compliance and operational personnel; (iv) assure that sufficient information is provided to the appropriate committee or senior management that addresses applicable risks, and the manner in which such risks are proposed to be addressed; (v) identify any "red flags" for further review once a CSFT has been approved and consummated (e.g., early un-winds); (vi) establish appropriate committees to review CSFT activity and/or review responsibilities and membership of review committees; and (vii) implement appropriate training and on-going review procedures.

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11 See Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities , 72 Fed. Reg. 1372 (January 11, 2007) (principles-based guidance to banks and other financial institutions with respect to their involvement in CSFTs, focused on identification of elevated risk CSFTs, and compliance with appropriate risk management principles with respect to business ethics, diligence, reporting, documentation, monitoring, auditing, approval and management information processes, and training).

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

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

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., 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, additional restrictions on information-sharing, etc., can be addressed.

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

4. 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.[12]

5. Focus on compliance with restrictions on affiliate transactions.[13]

   a. Although Sections 23A and 23B of the Federal Reserve Act[14] 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

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12 See, e.g., Confidential Information Supplement to Loan Syndications and Trading Association [("LSTA")] Code of Conduct (Exposure Draft: August 27, 2008), and Statement of Principles for the Communication and Use of Confidential Information by Loan Market Participants (LSTA, December 2006); Remarks of SEC Associate Regional Investor Rosenfeld (December 4, 2007) and of SEC Associate Director Firestone (November 19, 2007) (regardless of their effectiveness as a defense in private securities litigation, so-called "big boy" letters are no defense to an SEC enforcement action); Joint Statement of Industry Associations Regarding the Communication and Use of Material Non-Public Information (December 13, 2006); Joint Market Practices Forum Statement of Principles and Recommendations Regarding the Handling of Material Non-Public Information by Credit Market Participants (October 2003) and European Supplement (May 2005).

See also Bank Activities Guide at Part V.A.3.d.

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

14 12 U.S.C. §§ 371c, 371c-1 ("Sections 23A/23B").

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).

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 (including portfolio companies); 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; (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 -- other than 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 credit limits, mark-to-mark requirements and collateral 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.

(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).

6. 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").[15]

[15] 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.

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.

7. 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:

   a. U.S. federal banking authority being relied upon for such investment;[16] e.g.:

      (i) The FRB's merchant banking rules.

      (ii) Treatment of merchant banking-type investments in financial services businesses (including such entities as 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).

      (iii) 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

[16] See generally BHCA § 4; 12 U.S.C. § 24(7); 12 C.F.R. §§ 7.1006, 211.8 et seq., 211.23, 225.170 et seq.; "Has Risk Management in Private Equity Kept Pace with Rapid Growth?," Federal Reserve Bank of Chicago Essays on Issues (December 2007).

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

corporations, non-bank banks, and similar banking entities.[17]

(iv) 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.

(v) Issues with respect to investments in real estate and/or physical commodities both merchant banking and those permissible as part of the "business banking":

(a) Entities engaged in "volumetric production payment" financing.

(b) Entities engaged in "cash forward commodity purchase agreements."

(c) Real estate under certain circumstances.

(vi) 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.

(vii) 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.

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

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

(ix) Bank authority in appropriate circumstances to (A) take as consideration for a loan, or for other banking services (1) 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 (2) warrants, options or conversion or other rights to acquire equity; and (B) invest in preferred securities and other equity instruments with debt-like characteristics.

b. Compliance with other applicable legal frameworks (e.g., Securities Exchange Act of 1934, Foreign Investment and National Security Act (as administered by the Committee on Foreign Investment in the U.S. (CFIUS)), Hart-Scott-Rodino Antitrust Improvements Act, 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, small business investment companies, insurance companies, casinos and gaming companies, mining companies), requirements involving sovereign wealth funds, 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.).

8. Review/evaluation of outsourcing or offshoring 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, legal compliance systems 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.

9. Focus on compliance with banking and securities law licensing/supervisory requirements in connection with international securities transactions/linkages.[18]

10. Evaluation of:

    a. Relationships between banks/broker-dealers and hedge funds, including in respect of space leasing, low-interest-rate personal loans, service arrangements, brokerage compensation, disclosures, and treatment of hedge fund clients in comparison with other clients. Areas of review include those related to (i) customer abuses, such as the misappropriation of funds; (ii) market abuses, such as disclosure and trading violations; (iii) 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; (iv) the role of prime brokers; (v) supervision of broker-dealer employees physically located at hedge fund clients; (vi) crossing large customer orders with hedge fund clients; (vii) insider trading by hedge funds, particularly with respect to "private investment in public equity" (PIPE) transactions; and (viii) "retailization" of hedge fund clients.[19]

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[18] See generally SEC Release No. 34-58047 (June 27, 2008) (proposed amendments to SEC Rule 15a-6); Department of Justice Release, July 2008 (enforcement of Internal Revenue Service ("IRS") summons for UBS Swiss account records relating to cross-border services provided by UBS to U.S. clients that allegedly facilitated tax evasion); Senate Permanent Subcommittee of Investigations Staff Reports: Dividend Tax Abuse: How Offshore Entities Dodge Taxes in U.S. Stock Dividends (September 11, 2008), Tax Haven Banks and U.S. Tax Compliance (July 17, 2008); IRS Release No. 2008-116 (October 16, 2008) (proposed amendments to "qualified intermediary" program for foreign banks).

See also Bank Activities Guide at Part XI.

[19] See, e.g., Best Practices for the Hedge Fund Industry – Report of the Asset Management Committee to the [PWG] (April 15, 2008) (recommendations with respect to hedge fund disclosure, valuation, risk management, trading and compliance practices); Principles and Best Practices for Hedge Fund Investors –

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b. Disclosure practices for banks with respect to bank hedge fund and other high-risk exposures, including those resulting from (i) special purpose entities, (ii) collateralized debt obligations, (iii) subprime and related mortgages, and (iv) leveraged finance.[20]

11. 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]

12. Focus on compliance with BSA/USA PATRIOT Act/OFAC requirements, including in respect of (a) anti-money laundering ("AML") programs, (b) tracking/monitoring/filing suspicious activity reports ("SARs"), (c) implementation of adequate customer identification/know-your-customer procedures, (d) trade finance,

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Report of the Investors' Committee to the [PWG] (April 15, 2008); Sound Practices for Hedge Fund Managers (Managed Funds Association, 2007).

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

[20] See, e.g., Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices (International Organization of Securities Commissions ("IOSCO"), October 2008); Report on Funds of Hedge Funds (IOSCO, June 2008); Leading-Practice Disclosures for Selected Exposures (Senior Supervisors Group, April 11, 2008); Hedge Fund Activities, Findings and Recommendations for Corporations and Investors (Conference Board Governance Center, March 18, 2008) Hedge Fund Standards: Final Report (January 2008); Principles for the Valuation of Hedge Fund Portfolios (IOSCO, November 2007).

[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).

(e) foreign correspondent account review, and (f) diligence -- "know your partner" -- in respect of U.S. and non-U.S. shell companies and tax havens.[22]

a. 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 (i) lack of management oversight and accountability; (ii) failure to meet reporting requirements; (iii) failure/absence of key controls; (iv) inadequate risk assessment; (v) inadequate/ineffective monitoring functions; (vi) due diligence failures; (vii) inadequate communication of information; (viii) failure to correct a previously reported problem or to respond to previous criticism; and (ix) concealing information from examiners.[23]

b. Key elements of SAR/AML programs identified in recent enforcement orders include the importance of a financial institution (i) fostering a culture of compliance with a "tone"

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22 See Interagency BSA Examination Manual.

See generally Bank Activities Guide at Part VIII.A.

23 In addition, class actions against banks which assert that the banks knowingly provided financial services to charities with links to terrorist organizations have raised questions about the extent of banks' diligence obligations and their potential liability. More than a dozen suits have been filed in N.Y. See, e.g., Rothstein v. UBS, Civ. No. 08-4414 (S.D.N.Y. May 9, 2008) (complaint) (alleging that UBS transactions with Iran violated U.S. sanctions and contributed to harms suffered by victims of Iranian-sponsored terrorists); Weiss v. National Westminster Bank, 453 F. Supp. 2d 609 (E.D.N.Y. 2006) (granting motion to dismiss with respect to allegation of aiding and abetting murder, attempted murder and serious bodily injury, but denying motion with respect to allegations of knowingly providing material support or resources to a foreign terrorist organization and unlawfully and willfully providing or collecting funds with the intention or knowledge that such funds would be used for terrorist purposes).

clearly set "at the top"; (ii) ensuring that the SAR/AML compliance function is adequately led, staffed and supported; (iii) maintaining detailed and up to date written policies that specifically address the institution's risks; (iv) 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; (v) 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; (vi) establishing a methodology to assign risk levels to different types of customers and products; (vii) providing enhanced due diligence for customers, products and geographic areas that pose higher risks; (viii) establishing internal procedures for reporting information about potentially suspicious transactions; (ix) engaging senior management in the process of identifying and reviewing significant SAR issues; (x) conducting rigorous independent testing; and (xi) responding quickly and fully to regulatory criticism and to issues identified by independent testing.

c. In evaluating OFAC related issues, it is important to recognize that (i) OFAC regulations assert jurisdiction over all U.S. persons, wherever located; (ii) OFAC regulations target direct and indirect relationships; (iii) 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 facilitation of services provided by others; and (iv) 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, implicate OFAC requirements.

d. On September 8, 2008, OFAC published, as an Interim Final Rule, an Appendix to 31 C.F.R. Part 501, Economic Sanctions Enforcement Guidelines (73 Fed. Reg. 51933 (September 8, 2008)). The Guidelines set forth a new 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.

   i. The General Factors include (A) willfulness or recklessness in causing a violation of law; (B)

awareness of the conduct giving rise to the apparent violation; (C) the actual or potential harm to sanction program objectives caused by the conduct in question; (D) the commercial sophistication and experience of the alleged violator, the volume of transactions at issue and any history of sanctions violations; (E) the existence and nature of the applicable OFAC compliance program at the time; (F) corrective actions taken; (G) the nature and extent of cooperation with OFAC; (H) the timing of the apparent violation in relation to the adoption of applicable prohibitions; (I) other federal or state enforcement actions already taken; and (J) the impact administrative action may have on promoting future compliance with U.S. economic sanctions.

ii. Voluntary self-disclosure is expected to be 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).

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

13. Focus on contingency planning, backup, and recovery programs.

14. Focus on information security, particularly in light of increased instances of identity theft.[24]

[24] See Bank Activities Guide at Part IX.F.

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

    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. Open issues in this context relate to (i) 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"; (ii) whether cash/physically settled forward transactions should be characterized as "identified banking products"; (iii) the scope of the applicable bank dealer exemption in the context of hedges of equity/credit derivative transactions; and (iv) the treatment of loan participations which do not fall literally within the scope of "identified banking products".[25]

    b. Compliance with the SEC's "Broker Push-out Rules" as reflected in Regulation R.[26]

    c. Top areas of interest for current SEC/FINRA broker-dealer examinations include:[27]

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[25] 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.

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

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

[27] See, e.g., SEC Compliance Alert (July 2008); Testimony of SEC Division of Trading and Markets Director Sirri before Subcommittee of Senate Banking Committee, June 19, 2008; Remarks of SEC Office of Compliance Inspections and Examinations Associate Director Gadziala, November 28, 2007.

See generally Bank Activities Guide at Part IX.E.

(i) Maintenance of an appropriate "culture of compliance", including (A) compliance oversight; (B) codes of conduct; (C), identification and control of compliance risks; (D) implementation of effective supervisory systems; (E) communication, education and training; (F) internal processes to monitor and audit the compliance system; (G) implementation of comprehensive policies, procedures, systems and controls tailored to the broker-dealer's business; (H) effective reporting and resolution of significant compliance issues; and (I) response to violations and sanctioning of non-compliant actions.

(ii) Risk management and internal controls, including (A) internal audit; (B) senior management involvement; (C) adequacy of resources and systems used for risk management; (D) Market, Funding, Liquidity, Credit and Operational Risks; (E) legal and compliance controls; (F) supervisory procedures; and (G) assimilation of new products and activities into risk management systems.

(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) misuse of customer trading information or other non-public information (e.g., front-running); (C) allocation of limited products, services or opportunities to favored clients or provision of special incentives or payments for use of products or services; (D) use of products or services of affiliates or favored clients; (E) playing multiple roles in a transaction or with respect to an issuer or client; (F) biased research and advice; (G) accounting, booking or reporting to achieve other interests; and (H) gifts and entertainment to and from clients.

(iv) Compliance controls in respect of branch offices and independent contractors.

(v) Sales practices, including suitability, disclosure of risks, costs and fees, unauthorized trading, 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, insurance products, penny stocks, private placements, illiquid or volatile securities and hedge funds.

(vi) Trading and pricing practices, including insider trading issues, front-running, misuse of customer trading data or other non-public information, 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) and policies and procedures to avoid market abuses.

(vii) Creation and marketing of structured finance products.

(viii) Financial issues, including net capital deficiencies and inaccuracies in computing net capital.

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

(x) Information security, including protection of customer information, on-line brokerage account intrusions and "leaking" of information about large trades to favored customers.

(xi) Business continuity practices.

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

d. With respect to investment advisers/investment companies, recent areas of compliance interest include:[28]

[28] See, e.g., SEC Compliance Alert (June 2008); Remarks of SEC Director Richards, March 20, 2008; Remarks of SEC Office of Compliance and Inspections Associate Director Gadziala, November 28, 2007; 2007 Coordinated Investment Adviser

(fn. cont.)

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

(ii) Conflict of interest disclosure/resolution (including in respect of trade allocations among clients and side-by-side management of hedge funds).

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

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

(v) Brokerage arrangements and satisfaction of best execution responsibilities.

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

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

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

(ix) Advertising/marketing and performance claims.

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Exams (NAASA, October 15, 2007); SEC: Steps Being Taken to Make Examination Programs More Risk-Based and Transparent (General Accountability Office, August 2007).

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

(x) Fair value pricing and valuation controls.

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

(xii) Information processing and protection.

(xiii) Proxy voting for clients (including documenting procedures and disclosure)

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

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