SIA COMPLIANCE AND LEGAL DIVISION ANNUAL SEMINAR

SECURITIES ACTIVITIES OF BANKS IN THE GLB ERA: ANTI-TYING GUIDANCE AND OPERATIONAL RISK ISSUES[1]

Hollywood, Florida
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This Outline is intended to address (I) recent guidance and developments in respect of bank/broker-dealer cross-marketing under Section 106 of the Bank Holding Company Act ("BHCA") Amendments of 1970 (the "Anti-tying Statute")[2] and Federal Reserve Board ("Board") regulations and interpretations thereunder; and (II) issues with respect to operational risk management (including regarding complex structured finance transactions) in the capital markets context from a legal and compliance perspective.

I. Cross-Marketing: Anti-Tying Concerns

A. Background

1. The Anti-tying Statute (which is implemented by the Board in Regulation Y, 12 C.F.R. § 225.7), provides that a bank may not condition the availability of a product or service (the "tying product") on its customer obtaining another product or service (a "tied product") from the bank or one of its affiliates, unless the tied product falls within a "traditional products exception" -- a loan, discount, deposit or trust service -- or another exception applies. The Anti-tying Statute

[1] Many of the matters discussed in this Outline (which is current as of January 9, 2006), as well as significant other capital markets developments relevant to securities activities of banks, are discussed in more detail -- and substantive legislative, administrative and regulatory background is provided -- in Tortoriello, Guide to Bank Underwriting, Dealing and Brokerage Activities (LegalWorks, 10th ed., 2006) (the "Bank Activities Guide").

[2] 12 U.S.C. § 1971 et seq.

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also applies to (a) "reciprocity arrangements", in which the pricing of a product or service for a customer is conditioned on the customer providing a product or service in return, and (b) "exclusive dealing arrangements", under which availability of a price for a product or service is conditioned on a customer agreeing not to use the products or services of a competitor.

2. Courts have adopted the view that the Anti-tying Statute imposes anti-tying restrictions on banks that are considerably stricter than generally applicable antitrust limitations. As the Board indicated in the Proposed Anti-tying Interpretation (defined below), unlike in respect of the antitrust laws, violation of the Statute does not require proof of market power, anti-competitive effect or more than an insubstantial impact on interstate commerce.[3]

3. In 1997, in its amendment to Regulation Y, the Board eliminated the former regulatory extension of the Anti-tying Statute to bank holding companies ("BHCs") and their non-bank subsidiaries, leaving restrictions on anti-competitive behavior by BHCs and such subsidiaries to the same general antitrust laws that govern their competitors. The Board also created exceptions from the statutory restriction on bank tying arrangements to allow banks greater flexibility to package products with their affiliates, as well as a "safe harbor" for tying arrangements outside the U.S. (defined by location of the customer).

4. In 2003, the Board issued a proposed interpretation of the Anti-tying Statute. See 68 Fed. Reg. 52024 (August 29, 2003) (solicitation of public comments) (the "Proposed Anti-tying Interpretation").[4] See also Today's Credit Markets, Relationship Banking and Tying (Office

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[3] See also, e.g., Highland Capital v. Franklin National Bank, 350 F.3d 558 (6th Cir. 2003) ("Highland Capital") (to same general effect).

[4] In addition, the Board proposed to adopt an exception under the Anti-tying Statute for financial subsidiaries of state non-member banks. 68 Fed. Reg. 51938 (August 29, 2003) (solicitation of public comments) (the "Proposed Financial Subsidiary Anti-tying Exception").

of the Comptroller of the Currency ("OCC"), September 2003) (the "OCC 2003 Anti-tying Report"); OCC Statement, dated August 25, 2003 (endorsing the Proposed Anti-tying Interpretation). [5]

a. According to the Proposed Anti-tying Interpretation, the Anti-tying Statute prohibits a bank from imposing a condition on a prospective borrower that requires the borrower to do any of the following in order to obtain a loan from the bank:

(i) Purchase an insurance product from the bank or an affiliate of the bank (a prohibited tie);

(ii) Obtain corporate debt or equity underwriting services from an affiliate of the bank (a prohibited tie);

(iii) Sell the bank or an affiliate of the bank a piece of real estate unrelated to the requested loan (a prohibited reciprocity arrangement); or

(iv) Refrain from obtaining insurance products or securities underwriting services from a competitor of the bank or from a competitor of an affiliate of the bank (a prohibited exclusive dealing arrangement).

b. Among the general points raised by, or relevant to, the Proposed Anti-tying Interpretation:

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[5] While this Outline is intended to checklist briefly certain more recent developments and interpretive issues with respect to the Anti-tying Statute (principally those related to the Proposed Anti-tying Interpretation) from a corporate/capital markets perspective, all aspects of the Proposed Interpretation and its implications are discussed in the Cleary Gottlieb Steen & Hamilton LLP Alert Memorandum, The Federal Reserve Board's Proposed Interpretation to the Anti-tying Provisions of the Bank Holding Company Act Amendments of 1970 (August 27, 2003). See also Bank Activities Guide at Part III.A.5; Tortoriello & Rozansky, "The Federal Reserve Board's Proposed Interpretation to the Anti-tying Provisions of the Bank Holding Company Act Amendments of 1970", Banking Law Journal (November/December 2003).

(i) Because the determination of whether a violation of the Anti-tying Statute has occurred is fact specific, examples used in the Proposed Anti-tying Interpretation by themselves do not represent a finding that any past action by a particular bank violated the Statute.

(ii) The Anti-tying Statute does not require a bank to extend credit or provide any other product to any customer; i.e., the Statute does not prohibit a bank from declining to provide credit to a customer so long as the bank's decision is not based on the customer's failure to satisfy a condition or requirement prohibited by the Statute.

(iii) The Anti-tying Statute applies only to tying arrangements that are imposed by a bank. The Statute does not apply to tying arrangements imposed by a non-bank affiliate of a bank. However, if a non-bank affiliate acts essentially on behalf of a bank in implementing a tying arrangement, the Statute's prohibitions may be implicated.

(iv) The Anti-tying Statute covers some activities that are not included in the conventional notion of tying. For example, the Statute prohibits banks from granting certain types of price discounts on the condition that the customer purchase one or more other products from the bank or an affiliate. It is expected, however, that, in final form, the Proposed Anti-tying Interpretation will clarify the extent to which banks may provide price discounts (including rebates) on various products -- or on bundled products -- based on customer use of the products (especially under

circumstances where products included in the bundle are available separately).[6]

(A) It is clear that there is no "perfect price" for any particular product or service when multiple products or services are offered to a customer. A bank's risk profile, risk tolerance, financial and cost structures and capital requirements, the interrelationships between -- and, thus, cost savings and efficiencies on -- different products and services (e.g., a lower cost of due diligence if that needed for a credit facility duplicates that needed for a concurrent securities offering), and bona fide customer relationships, could all be important components in pricing decisions.

(B) Board staff has previously clarified that banks may take into account a customer's overall relationship with the bank when pricing a product in much the same way a bank would evaluate a customer's credit history.[7]

(C) This conclusion is consistent with statements made by Wayne Abernathy, Assistant Secretary of the Treasury for Financial Institutions (November 9, 2003), who cautioned against confusing illegal "tying" of financial products with the legal discounts banks give to good customers who buy additional services (even if the services are securities services, and even if the good customer relationship was established through lending).

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[6] See generally American Banker, June 8, 2005 (Bank of America waiver of mortgage closing fees for customers who use its other products and services).

[7] See Remarks by Board General Counsel Mattingly, May 23, 1993.

(D) OCC Bulletin No. 95-20 (April 14, 1995) sets out examples of arrangements allowed under the Anti-tying Statute. See also OCC 2003 Anti-tying Report; "Legality of Relationship Banking Under Bank Anti-tying Restrictions" (American Bankers Association/American Bankers Association Securities Association ("ABASA"), May 28, 2003) (among the scenarios under which tying is legal are (1) when a customer seeks multiple products to obtain more favorable terms; (2) when a customer initiates the tie; (3) when a bank refuses to renew a line of credit because its overall relationship with the customer is not profitable enough; (4) when a non-bank unit of a BHC conditions a loan on a customer obtaining a service from another non-bank unit; (5) when a lender links traditional bank products; or (6) when a bank grants a loan if the borrower selects another, more profitable service from a menu of traditional bank products and other products).

c. Approximately 40 comments were filed with the Board in respect of the Proposed Anti-tying Interpretation.

(i) While the vast majority commend the Board on its approach as set out in the Proposed Anti-tying Interpretation (and suggest various clarifications, amendments and modifications), comments on the Proposed Interpretation run the full range from those which request that the Board limit the application of the Anti-tying Statute only to those arrangements which would violate the antitrust laws,[8] to those which

[8] See, e.g., "Economic Power and the Bank Tying Provisions" (September 2003) and related Letters to the Board, dated August 2, 2005, March 30, 2004, September 30, 2003 (comments of Bank of America, Citigroup, Deutsche Bank, J.P. Morgan Chase & Co. and UBS (the "Bank Anti-tying Group")); ABASA Comment Letter, dated (fn. cont.)

strongly criticize the Board for purportedly undercutting Congressional intent as expressed in the Statute.[9]

(ii) The Department of Justice Antitrust Division Comment Letter, dated November 7, 2003, stated:

> "[T]he prohibitions on tying within [the Anti-tying Statute] are much broader than those found in the federal antitrust laws. While the [Proposed Anti-tying Interpretation] brings [the Statute] closer to the scope of the federal antitrust laws by stating that it pertains only to coercive, not voluntary, tying, the Division is still concerned that the [Proposed Interpretation's] interpretation of [the Statute] may continue to prohibit some pro-competitive practices, particularly multi-product discounting. Additionally, the Division is concerned that the [Statute] disadvantages banks as competitors in markets in which banks and non-banks compete, thus lessening competition and harming consumers. The Division, therefore, recommends that the [Board] interpret [the Statute] to be consistent with, and not broader than, the federal antitrust laws. In the event the Board determines that court precedent precludes such an interpretation, the Division recommends that

(fn. cont.)
September 30, 2003 (the "ABASA Comment Letter"); Financial Services Roundtable Comment Letter, dated September 30, 2003 (the "FSR Comment Letter"); Association of the Bar of the City of New York Comment Letter, dated September 30, 2003.

9 See, e.g., Lazard Freres & Co. Comment Letter, dated September 30, 2003.

the Board exercise its statutory right to expand the range of exemptions to [the Statute].

"The Division recommends that [the Anti-tying Statute] should not be interpreted to prohibit conduct that the federal antitrust laws do not find anticompetitive. Failing that, at a minimum, the [Statute] should be limited to ties involving small businesses and individual consumers."

(iii) Timothy Naegle, author of the Anti-tying Statute, has been very critical of the Proposed Anti-tying Interpretation, and has concluded that it is debatable whether the Statute has been an effective tool for preventing bank misconduct. He has surmised that the lack of very many "plaintiff-friendly" decisions under the Statute is the result of (A) the lack of written documentary evidence (e.g., particularly in the context of orally-imposed tying arrangements), (B) uncertainty as to what constitutes impermissible conduct, (C) perceived adverse consequences in suing a bank (e.g., in terms of access to credit and other banking services), and (D) possible judicial/regulatory bias. He believes, however, that the Statute could play an important role in achieving public policy goals, but urges regulators and courts to promote the rights of private litigants to police tying abuse.[10]

d. The Bank Anti-tying Group made Joint Submission to the Board in November 2004 (the "2004 Bank Submission") proposing (i) a safe-harbor exemption to the Anti-tying Statute for transactions which involve large, sophisticated customers (the "Proposed Large Customer Safe-Harbor Exemption"), and (ii) a complementary interpretation with respect to the

[10] See Naegele, "The Bank Holding Company Act's Anti-tying Provision: 35 Years Later", Banking Law J. (March 2005).

standard of bank "coercion" required for a violation of the Anti-tying Statute (the "Proposed Coercion Interpretation").

(i) The rationale for the Proposed Large Customer Safe-Harbor Exemption is based on the notion that large and sophisticated customers are unlikely to be forced or coerced by a bank to take unwanted products or services. Based on that premise, the 2004 Bank Submission contends that tying/reciprocal dealing arrangements between a bank and such large/sophisticated customers should not raise any of the anti-competitive concerns that the Anti-tying Statute was intended to prevent.

It is not expected, however, that the Board will act favorably on the proposed Exemption in the near future (it at all).

(ii) The Proposed Coercion Interpretation articulates a "coercion analysis" to be applied as guidelines for identifying customers that cannot be coerced by banks into accepting unwanted products/services.

(A) The 2004 Bank Submission recommends that the Board clarify that the "coercion analysis" (set out in the Proposed Coercion Interpretation) and the "meaningful option" analysis (set out in the Proposed Anti-tying Interpretation and described in Part I.C.1.b below) for mixed-product arrangements be applied as two separate tests under the Anti-tying Statute (i.e., in the context of circumstances where the Proposed Large Customer Safe-Harbor Exemption, or any other exemption from the Statute, is not available).

(B) Certain key principles of the "coercion analysis" articulated in the Proposed Coercion Interpretation include the following:

(i) A violation of the Anti-tying Statute may occur only if a bank coerces or forces a customer to obtain (or provide) the tied product as a condition to the customer obtaining the desired product from the bank.

(ii) The Anti-tying Statute does not apply where a customer uses its business leverage to seek to obtain from a bank or its affiliates a package of products that the customer desires, in which case the bank or its affiliate is free to negotiate with and propose to the customer a counteroffer with regard to one or more products.

(iii) A bank may present a tying arrangement to a customer so long as the bank reasonably believes that the customer is not being coerced or forced to accept the arrangement.

(iv) Coercion requires force that allows a bank to impose a condition or requirement on a customer. Coercion does not occur simply because a bank offers an economic incentive for a customer to agree to its proposal; for coercion to occur, the customer must be unable to choose freely among the choices that are made available to it. Normal "give and take" in a commercial context is cogent evidence that the bank cannot coerce the customer.

(v) A bank cannot coerce a customer that has real alternatives; a bank can only negotiate with such a customer. If a

bank can show that a customer has one or more bona fide alternative sources of the desired product or that one or more other financial institutions are bidding on a bona fide basis to provide the desired product to such customer on similar terms, then no coercion or force would be involved unless there is some demonstrable reason why the customer is being prevented from choosing among the alternative sources.

(vi) Proof that no coercion is involved may be shown by the nature of the customer relationship as well as by the competitive landscape. For example, a bank may present a tying arrangement to a customer that has a well-trained staff (e.g., a customer that has a sizable treasury operation) who are capable of negotiating favorable terms for a desired product on a stand-alone basis or tied to other products or services.

(iii) The 2004 Bank Submission included an extensive analysis of the competitiveness of various credit markets in order to provide additional support for the adoption of the Proposed Large Customer Safe-Harbor Exemption.

(A) According to the Submission, the analysis demonstrates that credit facilities involving "large customers" are inherently competitive, and therefore, that such customers cannot be coerced by any bank. In addition, the Submission reached the conclusion that the syndicated loan market is an intensely competitive market in which no bank can coerce customers into accepting unwanted products and services.

(B) The Board questioned whether borrowing needs of certain customers might be so large that only a few banks could effectively perform the role of lead arranger. Responses (see, e.g., Bank of America Letter to the Board, dated February 22, 2005) stated that this is not a realistic concern. It postulated that:

(1) There is significant lending capacity in syndicated loan markets (40% over-subscription for investment grade borrowing in 2004).

(2) There is intense competition among potential lead arrangers.

(3) Large borrowers are capable of obtaining alternative funding sources.

(4) The reputational risk of attempting to coerce large borrowers into tying arrangements would be devastating.

(C) Compare Association of Financial Professionals 2004 Credit Access Survey – Linking Corporate Credit to the Awarding of Other Financial Services (June 2004) (the "AFP 2004 Credit Survey") (stating that (1) 96% of the corporate finance executives at companies with revenue of $1 billion or more who responded said that they had been pressured by lenders to buy underwriting, merger advice and other services from a bank in exchange for loans, (2) nearly two-thirds of such executives said that a bank had denied credit or raised loan prices because the executives did not buy other services, and (3) almost half of such executives said that such pressure had risen in the past year).

(iv) A study on the tying of lending and equity underwriting supports the notion that tying arrangements may benefit both banks and equity issuer customers, that tying lowers issuers' (and especially non-investment grade issuers') financing costs through lower underwriting fees and discounted loan yield spreads, and that banks can realize cost savings from efficiencies (e.g., informational economies of scale attributable to using the same client-specific information for multiple purposes) resulting from combining lending and underwriting. The study also indicates that both commercial and investment banks tie lending and underwriting and offer price discounts (although investment banks and commercial banks appear to compete through different components of the tied deal -- commercial banks are more likely to offer discounted yield spreads on tied loans while investment banks are more likely to discount the underwriter spread). See Drucker & Puri, The Tying of Lending and Equity Underwriting (April 2004). See also Mullineaux, Tying and Subsidized Loans: A Doubtful Problem (May 2003) (concluding that tying is not a rational strategy and that no valid inferences about tying can be drawn from simple comparisons of rates on loans with those on bonds or credit default swaps).

e. It is unclear when (or whether) the Proposed Anti-tying Interpretation will be finalized.

5. The General Accounting Office ("GAO") Report Bank Tying: Additional Steps Needed to Ensure Effective Enforcement of Tying Prohibitions (2003) (the "GAO Report") concluded that the application of the Anti-tying Statute depends on the facts and circumstances of specific transactions, and that this has contributed to widespread confusion about what is prohibited and what is permitted. The GAO concluded that there was little evidence of bank violations of the Statute, and that Board/OCC targeted examinations of the anti-tying policies and procedures of several large commercial banks did not uncover any significant problems.

a. The GAO concluded that because the facts, if any, that would suggest a tying violation generally would not be found in the loan documentation that banks maintain, and because bank customers have been unwilling to file formal complaints, effective enforcement of the Anti-tying Statute is difficult.[11]

b. The GAO recommended that the Board and the OCC (i) take additional steps to ensure effective enforcement of the Anti-tying Statute by enhancing the information that they receive from corporate borrowers, (ii) develop a broad-based communication strategy to better educate the corporate community about which activities are prohibited and which are permitted, and (iii) establish contact points to answer questions about specific transactions, as well as to accept complaints.[12]

B. Essential Elements of an Impermissible Tying Arrangement

1. The Arrangement Must Involve Two Products -- a Desired Product and a Tied Product

a. In order for a tying arrangement to exist under the Anti-tying Statute, the arrangement must involve two or more separate products. A bank does not violate the Statute by requiring a customer to obtain (or provide) two or more aspects of a single product from (or to) the bank or an affiliate, or by conditioning the availability or varying the price of a product on the basis of the characteristics or terms of that product. For example, a bank does not violate the Statute by requiring:

[11] See also Highland Capital (discussing ability of a claimant to use circumstantial evidence to prove violation of the Anti-tying Statute; violation not found).

[12] See also OCC Release NR 2004-23 (March 23, 2004) (OCC contact information for questions concerning tying).

(i) A prospective borrower to provide the bank specified collateral in order to obtain the loan or to obtain the loan at a favorable interest rate; or

(ii) An existing borrower to post additional collateral, accept a higher interest rate, or provide updated or additional financial information as a condition of renewal of the loan.

b. According to the Proposed Anti-tying Interpretation, as a general matter, two products will be separate and distinct for purposes of the Anti-tying Statute only if there is sufficient demand for each of the products individually, such that it would be efficient for a firm to provide the products separately.

(i) The Board noted that certain types of derivative products -- such as interest rate and foreign exchange swaps -- are often sold by bankers and purchased by customers in connection with lending transactions.

(ii) The ABASA Comment Letter suggested that the standard set forth in the Proposed Anti-tying Interpretation should be broad enough to permit banks to consider as a single product two or more interrelated products that, if offered together, could be offered at a lower price than if offered separately (e.g., a loan that requires an interest rate swap, a loan secured with stock with an equity collar, or derivatives offered in conjunction with lending transactions).

c. A Board Letter, dated February 2, 2004, addresses the permissibility under the Anti-tying Statute of a securities lending program offered by Merrill Lynch Bank and its affiliate, Merrill Lynch Private Finance Inc. ("MLPF"). Under the program, the Bank and MLPF offer loans subject to the requirement that the securities collateralizing the loans be kept in collateral accounts with a broker-dealer affiliate of the Bank/MLPF under circumstances where (i) the lender has a security interest in all securities in the account, (ii) the

customer is not required to place any securities in the account beyond those necessary to satisfy the lender's collateral requirement, and (iii) the customer is not required to pay a separate fee to establish or maintain the account. The Letter concluded that (A) by requiring collateral for a securities-based loan, the Bank/MLPF do not require that the customer obtain any product separate from the loan itself; and (B) the fact that the lenders require the pledged securities to be held in an account at an affiliate does not make the collateral, or the account, a product separate from the loan that the collateral secures. See also Board Letter to National City Corp. ("NatCity"), dated August 18, 2003 (exception from the Anti-tying Statute to permit NatCity subsidiary banks to require borrowers whose loans are secured with publicly traded securities to keep those securities in accounts at a broker-dealer affiliate).

2. Bank-Imposed Condition or Requirement

a. Existence of a Condition or Requirement

(i) In order to prove a violation of the Anti-tying Statute, a claimant must prove that the purchase of a tied product was a "mandatory condition or requirement" of obtaining the tying product from the bank.[13]

(ii) This standard does not prohibit:

(A) A customer from deciding on its own to award some of its business to a bank or an affiliate as

[13] See, e.g., Highland Capital; OCC Interpretive Letter No. 991 (March 11, 2004), CCH Fed. Banking L. Rep. ¶81-517 (no prohibited tie resulted from discount offered on homeowners insurance premiums by an insurance affiliate of a national bank; discount was not conditioned on customer obtaining another product or service, and the Anti-tying Statute does not apply to the insurance agency affiliate of a national bank).

a reward for previously providing credit or other services.

(B) A bank from granting credit to a customer based on the desire or hope that the customer will obtain additional products from the bank even if the bank conveys to the customer this desire or hope for additional business.

(C) Cross-marketing the full range of products offered by the bank or its affiliates, encouraging an existing customer to purchase additional products, or cross-selling multiple products ("whether suggestive or aggressive").

(D) Offering multiple products as a package if the bank also offers the customer the opportunity to obtain the customer's desired product (or a discount on the desired product) from the bank separately from the allegedly tied product.

b. Condition or Requirement Imposed on the Customer by the Bank

(i) Even if a condition or requirement exists tying a customer's desired product to another product, a violation of the Anti-tying Statute may occur only if the condition or requirement was imposed on the customer by the bank.

(ii) This does not include "voluntary" (or "reverse") customer-initiated ties, including when a customer believes that it stands a better chance of securing a scarce commodity (such as credit) by "volunteering" to accept other products or services from the bank or its affiliates.

(iii) It should also be possible in appropriate circumstances for a bank to respond to a request for a particular "voluntary tie" with a counter-offer suggesting a

modified or different "tie" so long as the counter-offer is reasonably related to the nature and scope of voluntary tie requested.

c. Factual Inquiry Required

(i) The specific facts and circumstances surrounding the bank-customer relationship often will be critical in determining whether a prohibited condition or requirement existed and whether the condition or requirement was imposed on the customer by the bank or was volunteered or sought by the customer.

(ii) The timing and sequence of the offers, purchases or other transactions between the customer and the bank or its affiliates that form the basis of the alleged tying arrangement, and the nature of the condition or requirement itself, may be particularly relevant in determining whether the customer was required to obtain (or provide) the tied product in order to obtain the desired product.

(iii) Other information that may be useful in determining whether a condition or requirement exists (and, if so, whether the bank coerced the customer into accepting the condition or requirement) includes (A) correspondence and conversations between the bank and the customer; (B) marketing or other materials presented to the customer; (C) the bank's course of dealings with the customer and other similarly situated customers; (D) the bank's policies and procedures; (E) the customer's course of dealings with the bank and other financial institutions; (F) the financial resources and level of sophistication of the customer; and (G) whether the customer was represented by legal counsel or other advisors.

C. Exceptions to the Anti-Tying Prohibitions

1. Tying Arrangements Involving Traditional Bank Products

a. Statutory and Regulatory Exceptions

(i) The Anti-tying Statute allows a bank to condition both the availability and price of any product on the requirement that the customer obtain a traditional bank product from the bank.

The Board has provided by regulation (12 C.F.R. § 225.7(b)(1)) that the traditional bank product exception also applies to traditional bank products obtained from affiliates of a bank.

(ii) Several facts are important in determining whether the traditional bank product exception applies in a given situation:

(A) The exception is available only if the tied product is a traditional bank product. The availability of the exception, however, does not depend on the type of desired (i.e., tying) product involved.[14]

(B) The exception applies only if the tied product is a defined traditional bank product. The Proposed Anti-tying Interpretation indicated that products that fall within the scope of the exception include, among others, the following:

[14] See, e.g., OCC Interpretive Letter No. 982 (September 29, 2003), CCH Fed. Banking L. Rep. ¶ 81-508 (bank may offer to provide underwriting services (a non-traditional product) to a customer on the condition that the customer utilize a letter of credit (a traditional product) issued by the bank).

(1) All types of extensions of credit, including loans, lines of credit, and backup lines of credit. (An "extension of credit" for this purpose does not include underwriting, privately placing or brokering debt securities.)

(2) Letters of credit and financial guarantees.

(3) Lease transactions that are the functional equivalent of an extension of credit.

(4) Credit derivatives where the bank or affiliate is the seller of credit protection.

(5) Acquiring, brokering, arranging, syndicating and servicing loans or other extensions of credit.

(6) Deposit accounts.

(7) Safe deposit box services.

(8) Escrow services

(9) Payment and settlement services (including check clearing, check guaranty, automated clearinghouse wire transfer and debit card services).

(10) Payroll services.

(11) Traveler's check and money order services.

(12) Cash management services.

(13) Trust services.

(14) Asset management services provided as fiduciary.

(15) Custody services (including securities lending services).

(16) Paying agent, transfer agent and registrar services.

(iii) The traditional bank product exception is arguably broad enough to cover (A) all types of derivative products, (B) all services provided in a "fiduciary capacity", (C) discretionary account management services (and related deposit-mutual fund "sweeps"), (D) investment and corporate finance advisory services, (v) packages of settlement services and mortgage loans, and (E) foreign exchange and related services.[15]

b. "Mixed-Product Arrangements"

(i) A bank may wish to provide a customer the freedom to choose whether to satisfy a condition imposed by the bank through the purchase of one or more traditional bank products or "non-traditional" products (a "mixed-product arrangement").

(ii) Where a bank offers a customer a mixed-product arrangement, further analysis may be necessary to determine whether the offer constitutes a tying arrangement prohibited by the Anti-tying Statute. If the customer that is offered the mixed-product arrangement has a meaningful option to satisfy the bank's condition solely through the purchase of traditional bank products, then the bank's offer would

[15] See, e.g., FSR Comment Letter; ABASA Comment Letter.

not be viewed as requiring the customer to purchase any non-traditional product in violation of the Statute.

(iii) The concept of a meaningful option is a real one and it is not clear that all banks have been as careful as they should be in presenting options to customers. For example, The AFP 2004 Credit Survey reported that over 60% of respondents from large companies indicated that they believe that banks would refuse to grant (or would reduce) the credit available to their companies if they did not award additional business. Over 45% of such respondents said that the pressure to award additional business had increased in the last year and 59% indicated that, over the past five years, a bank had denied them credit or changed credit terms because the company did not award the bank other business. According to the Survey, large companies are more likely to be subjected to banks' attempts to link credit access to other financial services.

(iv) According to the Proposed Anti-tying Interpretation, the determination of whether a mixed-product arrangement comports with the Anti-tying Statute often will depend on the nature and characteristics of the arrangement and the customers to which the arrangement is offered.

(v) "Relationship banking" should be permissible under the Anti-tying Statute. For example, the Proposed Anti-tying Interpretation indicated (the "Hurdle Rate Example") that if:

(A) a bank and its affiliates periodically review the overall profitability of their combined business relationships with a corporate customer to determine whether the profitability of the customer's aggregate business relationships with the bank and its affiliates meet the bank's internal profitability threshold ("hurdle rate");

(B) in accordance with this policy, the bank conducts a review of the overall profitability of the customer's relationships with the bank and its affiliates and determines that the profitability of the customer's existing relationships (e.g., a bank credit facility) does not meet the hurdle rate; and

(C) in light of this review, the bank informs the customer that the bank will not renew the customer's credit facility unless the customer commits to provide the bank or its affiliates sufficient additional business to allow the customer's overall relationships to meet the hurdle rate (but under circumstances where the bank does not tie renewal of the credit to the purchase by the customer of any specific products from the bank or its affiliates but rather offers a "wide" variety of traditional bank products, as well as underwriting services and other non-traditional products);

the bank's actions would be permissible under the Anti-tying Statute if the customer could reasonably obtain sufficient traditional bank products to permit the customer to meet the hurdle rate.

The Proposed Anti-tying Interpretation indicated that a bank would provide a customer a meaningful option even though the customer had a long-standing arrangement with another financial institution, so long as the customer may legally transfer traditional bank product business to the bank and the bank would be able to satisfy the customer's need for such a product.

While authorizing mixed product arrangements essentially validates the principles of relationship banking, a number of questions remain, and the Board has been asked to:

(A) Confirm that it would be permissible for the "traditional bank product" component of a mixed product arrangement to involve "traditional bank products" provided by affiliates of banks, as well as by banks themselves.

(B) Confirm that it should be possible for a bank to vary the price of a "desired product" as part of the structure of a mixed product arrangement, or otherwise offer bundled products at "all-in" prices.

(C) Confirm that if a bank does not offer a "wide" variety of traditional bank products as a general matter, it should nonetheless be possible for the bank to offer a mixed product arrangement so long as the customer has a meaningful option to satisfy the bank's return requirements either through a variation in the price of the tying product itself (coupled with a more limited choice of one or more traditional bank products) or through the choice of a non-traditional product.

(D) Confirm that a bank may price traditional bank products included in a mixed-product arrangement in whatever manner the bank believes in good faith is appropriate under the circumstances (including, if so determined by the bank, at a price higher than the price that a competitor might charge in respect of the same or similar traditional products).

2. Reciprocity Exceptions

a. The reciprocity restrictions of the Anti-tying Statute generally prohibit a bank from conditioning the availability or price of a product on a requirement that the customer provide another product to the bank or an affiliate, subject to an exception

where the tied product is to be provided to the bank and is related to and usually provided in connection with a traditional bank product (a "usually-connected product"). The Board has extended this exception by regulation (12 C.F.R. § 225.7(b)(1)(ii)) to include situations where a bank requires the customer to provide a usually-connected product to an affiliate of the bank.

b. Facts that may be relevant in determining whether a bank's demand that a customer provide an additional product is appropriate include (i) the relationship between the tied product and the desired product, (ii) whether the practice protects the value of the bank's credit or other exposures, (iii) whether the practice is usual in the banking industry in connection with the type of product involved, and (iv) whether the condition was imposed by the bank principally to reduce competition or to allow it to compete unfairly in the market for the tied product.

c. Examples of permissible usually-connected products include:

(i) A bank conditions the availability of secured credit on a requirement that the customer obtain insurance, for the benefit of the bank, that protects the value of the bank's security interest in the collateral.

(ii) A bank requires affiliated parties of a troubled borrower to pay down their loans with the bank prior to renewing or advancing additional credit to the borrower, or requires the borrower's owners to guaranty the borrower's debt.

d. The Proposed Anti-tying Interpretation noted that a reciprocity arrangement involving a particular product does not violate the Anti-tying Statute simply because the arrangement is not frequently imposed in banking transactions, since contractual agreements between banks and their customers often are tailored to account for the characteristics of the individual customer and the specific transaction at issue.

3. Exclusive Dealing Exception

a. The Anti-tying Statute generally prohibits a bank from conditioning the availability or price of a bank product on a requirement that the customer not obtain another product from a competitor of the bank or a competitor of an affiliate.

b. However, the Anti-tying Statute contains an exception to its exclusive dealing restriction for situations where the condition is "reasonably imposed by the bank in a credit transaction to ensure the soundness of the credit". This exception permits a bank, when consistent with appropriate banking standards, to condition the availability of a loan to a customer on a requirement that the customer not borrow from other sources (and not pledge any collateral securing the loan to other entities). This exception would also permit a bank to condition the availability of floating-rate credit on a requirement that the borrower hedge its exposure by purchasing an interest rate swap, and limiting the permitted swap counterparties to those with a minimum credit rating (which could include affiliates of the bank).

4. Regulatory Safe Harbors

a. Combined-Balance Discount Safe Harbor

In 12 C.F.R. § 225.7(b)(2), the Board granted a safe harbor for combined-balanced discount packages if they are structured in a way that does not, as a practical matter, obligate customers to purchase non-traditional products in order to obtain the discount. The conditions required for this safe harbor are that (i) the bank must offer deposits; (ii) all deposits must be eligible to be counted toward the minimum balance; and (iii) deposits must count at least as much as non-deposit products toward the minimum balance.[16]

[16] For a selection of Board interpretations and Orders with respect to combined-balance discounts, see, e.g., Board Letters, dated November 26, 2002 (defining all members (fn. cont.)

b. Foreign Transactions Safe Harbor

(i) In 12 C.F.R. § 225.7(b)(3), the Board granted a regulatory safe harbor from the Anti-tying Statute for transactions between a bank and a customer if (A) the customer is a company that is organized outside the U.S. and has its principal place of business outside the U.S.; or (B) the customer is an individual who is a citizen of a country other than the U.S. and is not resident in the U.S.

(ii) While this safe harbor would generally be available for a loan transaction entered into by a bank with a foreign company even if (A) the loan is partially guaranteed by a U.S. affiliate of the foreign company, or (B) the foreign company directs the bank to disburse a portion of the loan to a U.S. affiliate, such a loan transaction with a foreign company would not qualify for the safe harbor if (1) the circumstances surrounding the transaction indicate that the borrower, in substance, was the U.S. affiliate and not the foreign company, or (2) the customer is a U.S. subsidiary of a foreign company.

(fn. cont.)
of a household or family to be a "customer" for purposes of combined-balance discount "safe harbor"), May 16, 2001 (combined-balance discount programs involving insurance products), June 2, 2000 (private label credit cards), December 6, 1996 (combined-balanced discount program excluding certain deposits, such as retirement plan deposits, private banking deposits, deposits held in branches of the same institution located in different states, and certain certificates of deposit); Huntington Bancshares, 82 Fed. Res. Bull. 688 (1996) (floorplan financing and two- and three-party paper); Capital One, 82 Fed. Res. Bull. 584 (1996) (secured credit cards); Fleet Financial Group, 80 Fed. Res. Bull. 1134 (1994) (combined minimum balance); First Union, 80 Fed. Res. Bull. 166 (1994) (brokerage services); Norwest, 76 Fed. Res. Bull. 702 (1990) (credit cards).

c. <u>Transactions Outside a Safe Harbor</u>

The Proposed Anti-tying Interpretation made clear that transactions that fall outside of the combined-balance discount or foreign transaction safe harbors may nonetheless be permitted under the Anti-tying Statute if they qualify for another exemption, or (in the case of the foreign transaction safe harbor) the transactions involved are so foreign in nature that they do not raise the competitive concerns that the Statute was designed to address.

Transactions that fall outside a safe-harbor require a customer-by-customer evaluation, while 12 C.F.R. § 225.7(b) exceptions (<u>i.e.</u>, the safe-harbor exceptions) do <u>not</u>.

D. <u>Definition of "Bank" for Purposes of the Anti-tying Statute</u>

1. A "<u>bank</u>" for purposes of the Anti-tying Statute includes virtually any U.S. depository institution, including commercial banks and savings banks, as well as "non-bank banks", limited-purpose trust companies, credit card banks, Edge Act and Agreement corporations, industrial loan companies and similar institutions (collectively "<u>non-bank depository institutions</u>").

2. The Anti-tying Statute also applies to any <u>U.S.</u> branch, agency or commercial lending subsidiary of a foreign bank. <u>See</u> 12 U.S.C. § 3106; 12 C.F.R. § 225.7.

   a. The term "<u>bank</u>" does <u>not</u> include foreign banks as such, even if the bank maintains one or more U.S. banking offices. Accordingly, the Anti-tying Statute does <u>not</u> apply to non-U.S. branches or offices of foreign banks.

   b. Although the Board has not made a formal statement on the matter, it would appear that a foreign bank's <u>offshore managed branch/booking center</u> (<u>see</u> 12 C.F.R. § 211.24(g)) should be treated as a <u>non-U.S.</u> branch for this purpose even if it is managed by a U.S. branch.

3. Although affiliates of a bank generally are not subject to the Anti-tying Statute, an affiliate of a non-bank bank or a non-bank depository institution is subject to the Statute in connection with any transaction involving the products of both the affiliate and the non-bank as if the affiliate were the bank and the institution were an affiliate. See 12 U.S.C. §§ 1843(f)(9)(B) and (h)(2).

4. The Proposed Anti-tying Interpretation states that the Anti-tying Statute also applies to all subsidiaries of a bank -- other than a "financial subsidiary" of a national bank or a state-chartered Federal Reserve System member bank (a "state member bank") under the Gramm-Leach-Bliley Act (the "GLBA") -- in the same manner as it applies to the bank itself. A "financial subsidiary" of a national bank or a state member bank, however, is treated as an affiliate of the bank, and not as a subsidiary of the bank, for purposes of the Statute. The Proposed Financial Subsidiary Anti-tying Exception would provide that a financial subsidiary of a state non-member bank would likewise be treated as an affiliate of the bank, and not as a subsidiary of the bank, for purposes of the Anti-tying Statute. Accordingly, if adopted, the Exception would equalize the treatment of financial subsidiaries of all U.S. banks under the Statute. See 12 U.S.C. § 1971 (national bank); 12 C.F.R. § 208.73(e) (state member bank).

5. Under 12 C.F.R. § 225.7, the Anti-tying Statute does not apply to tying arrangements entered into by any BHC non-bank subsidiary.

6. Savings associations are subject to anti-tying restrictions under the Home Owners Loan Act that are virtually identical to those applicable to banks under the Anti-tying Statute. See 12 U.S.C. § 1464(q); 12 C.F.R. § 536.30.

E. Definition of "Affiliate" for Purposes of the Anti-tying Statute

1. The term "affiliate" with respect to a bank under the Anti-tying Statute generally means any company or natural person that controls the bank, and any company that is controlled by such company or person (other than the bank itself).

a. A bank's BHC (or GLBA financial holding company ("FHC")), as well as subsidiaries of the BHC/FHC, are affiliates of the bank for purposes of the Anti-tying Statute.

b. Certain companies that control banks, but are not considered BHCs for purposes of the BHCA, are not considered bank affiliates for purposes of the Anti-tying Statute (e.g., certain companies that hold shares in a fiduciary capacity).

c. The Board has reserved judgment on whether a bank-advised investment fund is "affiliated" with its adviser for purposes of the Anti-tying Statute.[17]

2. While the Anti-tying Statute generally does not apply to tying arrangements imposed by an affiliate of a bank, a bank may not participate in a transaction in which an affiliate has nominally imposed a condition on a customer that the bank is prohibited from directly imposing under the Statute if the affiliate is acting on behalf of, as agent for, or in conjunction with, the bank with respect to that transaction.

a. A bank should not have a pre-arrangement or understanding with an affiliate to fund a loan for which the affiliate acts as syndicate manager if the affiliate has conditioned the availability (or price) of its syndication services on a requirement that the customer obtain securities underwriting services from the affiliate.

b. If an affiliate of a bank has conditioned the availability (or price) of a bridge loan on a requirement that the customer hire the bank's securities affiliate as an underwriter for the company's follow-on bond offering, the bank should not have an arrangement or understanding with the affiliate at the time

[17] Compare Fleet Financial Group, 80 Fed. Res. Bull. 1134 (1994) (silent on the matter) with 59 Fed. Reg. 9216 (February 25, 1994) (solicitation of public comments), 59 Fed. Reg. 29667 (August 4, 1994).

the bridge loan is made to purchase the loan (or a participation in the loan) from the affiliate.

F. Internal Controls to Ensure Compliance with the Anti-tying Statute

1. Anti-tying Policies, Procedures and Systems

a. Scope of Policies

(i) A bank's anti-tying policies and procedures should describe the scope of the Anti-tying Statute and prohibited tying arrangements. A bank should ensure that its policies (including those concerning credit approval, new product approval and pricing, and marketing) reflect the Statute's prohibitions and:

(A) Permit personnel with questions concerning the Statute or its application to a particular transaction to discuss the issue with the bank's compliance or legal department.

(B) Include procedures for the receipt, handling and resolution of customer complaints alleging a violation of the Statute.

(C) Prohibit any employee from taking adverse action against a customer because the customer submitted a complaint to the bank or a federal banking agency.

(ii) While the type of anti-tying policies, procedures and systems appropriate for a particular bank depends on the size of the bank, and the nature, scope and complexity of the bank's activities (including activities conducted in conjunction with affiliates), in general the following compliance principles/strategies should be considered:

(A) Oral statements (in addition to written requirements) can give rise to a violation of the Anti-tying Statute.

(B) Preparation of internal documents (such as minutes of meetings with clients), may be helpful in monitoring compliance.

(C) Written acknowledgements by a client as to the voluntary nature of a request for a "cross-sale" or "packaged offering" may be helpful for a bank to conclude that a "package" proposal constitutes a permissible "voluntary tie".

(D) If warranted by the circumstances, separate agreements between the same (or affiliated) parties may be viewed together under the Anti-tying Statute. Courts or regulators may treat even ostensibly unrelated contracts or letters as connected to one another when determining whether an unlawful tie exists.

(iii) An important predicate to any anti-tying policy -- particularly in the context of mixed product offerings -- is to assure ongoing compliance with the "affiliate transaction" requirements of Section 23B (defined below); i.e., assuring, at a minimum, that, as between a bank and its affiliate, the bank is properly compensated for any service or product it provides, even if any "keep whole" payment comes from the affiliate itself rather than, e.g., directly from the borrower.

b. Customer Complaints

Customer complaints alleging tying should be properly investigated and resolved.

(i) Depending on the circumstances, regulatory action could be taken by federal bank regulatory agencies, by the Justice Department or, possibly, if a bank's broker-

dealer affiliate is purportedly involved in the alleged tying, by the National Association of Securities Dealers (the "NASD") and/or the Securities and Exchange Commission (the "SEC"). See also Part III.A.5.g below.

(ii) Regulatory enforcement actions could involve civil penalties and could affect the "well managed" status of a bank or FHC for regulatory purposes.

(iii) The Anti-tying Statute provides for treble damages in the event of a successful demonstration by a customer of a statutory violation, together with the cost of suit, "including a reasonable attorney's fee". 12 U.S.C. § 1975.

(iv) Risk to a bank's reputation, as well as to other aspects of its operational risk management, of violations of the Anti-tying Statute cannot be ignored.

c. Education and Training

(i) A bank should ensure that its personnel receive education and training concerning the Anti-tying Statute. Training should focus on providing personnel with a framework to identify and address anti-tying compliance issues (not on providing "hints" on how to tie without getting caught).

(ii) The scope and frequency of training should be tailored to the nature and scope of the person's or department's functions, with greater resources devoted to those positions or departments that present the greatest legal or reputational risk (e.g., corporate relationship managers, syndicated lending personnel, persons with authority to approve credit extensions or establish pricing policies for the bank, and other personnel who market bank products).

(iii) A bank should review its employee compensation programs to ensure that such programs do not provide inappropriate incentives to tie products in a manner prohibited by the Anti-tying Statute.

d. Compliance Function

(i) A bank's compliance function should take a lead in monitoring compliance with the Anti-tying Statute. Appropriate compliance activities may including reviewing periodically:

(A) The bank's policies -- to ensure that they are updated as necessary to reflect changes in the bank's business or applicable laws, regulations or supervisory guidance and to provide appropriate personnel training.

(B) The bank's marketing materials and individual transactions -- to test bank compliance.

(ii) A bank's internal audit function should periodically review and test anti-tying policies and systems.

(iii) Compliance and internal audit programs should be designed and periodically evaluated to test adherence to legal requirements and policies, focusing on areas that may pose a higher risk (e.g., extensions of credit by a bank to support a securities offering where the bank's affiliate is acting as underwriter, syndicated loans and fee-sharing arrangements).

2. Internal Control and Recordkeeping Requirements for Banks Offering Mixed-Product Arrangements Outside a Regulatory Safe Harbor

a. A bank's policies on mixed-product arrangements should reflect how the bank establishes a good faith belief that a customer offered such an arrangement would be able to satisfy the condition associated with the arrangement through the purchase of traditional bank products.

b. The Proposed Anti-tying Interpretation requires a bank to evaluate its mixed-product arrangements on a customer-by-customer basis, and it does not appear likely that the Board will permit such evaluation to be done generally on the basis of classes of customers.

c. The cost and compliance burden of performing a fact-specific customer-by-customer analysis could be significant (and possibly uneconomical). See, e.g., Bank Group 2004 Comment.

d. According to the Proposed Anti-tying Interpretation, a bank's policies generally should address:

(i) The factors and types of information that the bank will review in forming a good faith belief that a customer offered a mixed-product arrangement has a meaningful option to satisfy the bank's condition solely through the purchase of traditional bank products, including such information as:

(A) The range and types of traditional bank products that are offered by the bank and its affiliates and included in the arrangement.

(B) The manner in which traditional bank products and non-traditional products are treated for purposes of determining whether a customer would meet the condition.

(C) The types and amounts of traditional bank products typically required or obtained by companies that are comparable to the customer in size, credit quality and business operations.

(D) Any information provided by a customer concerning the types and amounts of traditional bank products needed or desired and the customer's ability to obtain those products from the bank or its affiliates.

(ii) The bank personnel authorized to make the analysis described above for individual customers and the training and guidelines provided these personnel.

(iii) The internal processes and controls, including approval and documentation requirements, the bank uses to ensure that its analysis is (A) performed for a customer before the mixed-product arrangement is put into final form, and (B) adequately reflected in the bank's records.

e. In mixed-product arrangements, a bank may not weigh, discourage the use of, or otherwise treat traditional bank products in a manner that is designed to deprive customers of a meaningful choice.

f. The bank's policies should ensure that any material information which the bank relies on in analyzing the types and amounts of traditional bank products likely required by a customer is current and reliable, recognizing that the information/analysis necessary for a bank to establish a good faith belief that a customer has a meaningful choice under a mixed-product arrangement may vary depending on the nature and characteristics of the arrangement and the types of customers to which it is offered (large, complex organizations as opposed to small businesses, longstanding customers as opposed to new customers, etc.).

3. <u>Ability of Banks to Offer Mixed-Product Arrangements to Individuals</u>

a. An individual may be more susceptible to subtle pressure by a bank to purchase a non-traditional product.

b. The safe-harbor discussed in Part I.C.4 above allows a bank to offer certain <u>combined-balance discount programs</u> to individuals <u>without</u> making a specific determination in respect of a particular customer.

c. If, when it finalizes the Proposal Anti-tying Interpretation, the Board requires an individual-by-individual evaluation of a

mixed-product arrangement, it will likely be more difficult for a bank to establish a good faith belief that such an arrangement provides an individual a meaningful option to satisfy the condition associated with the arrangement solely through the purchase of traditional bank products without a detailed analysis of the individual's financial needs and capabilities.

G. NASD Developments

1. NASD Notice to Members No. 02-64 (September 2002) (the "NASD Tying Notice") expressed concern about the practice of tying commercial credit to investment banking and noted that tying issues usually arise in three contexts: (a) bridge loans in which the loan is intended to be repaid out of the proceeds of a bond offering; (b) backup credit facilities that support a company's issuance of commercial paper; and (c) syndicated loans. The NASD cautioned its members that aiding and abetting a violation of the BHCA by an affiliated bank would violate "just and equitable principles of trade."

a. The NASD concluded that a threat by a broker-dealer to discontinue research coverage of, and stop making a market in, stock of an issuer if the issuer did not select the broker-dealer for investment banking services on terms desired by the broker-dealer but not wanted by the issuer was "inconsistent with high standards of commercial honor and just and equitable principles of trade" required by NASD Rule 2110. See Letter of Acceptance, Waiver and Consent re U.S. Bancorp Piper Jaffray (No. CAF020020) (July 2002).

b. Other NASD Rules could also have implications in the tying context. See, e.g.:

(i) Rule 113: NASD Rules "shall be interpreted . . . so as to require that all practices in connection with the investment banking and securities business shall be just, reasonable and not unfairly discriminatory".

(ii) Rule 2120: "No member shall effect any transaction in, or induce the purchase or sale of any security by

means of any manipulative, deceptive or other fraudulent device or contrivance".

(iii) Rule 2310: "Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing".

(iv) Rule 2710(c)(1): "No member or person associated with a member shall participate in any manner in any public offering of securities in which the underwriting or other terms or arrangements in connection with or relating to the distribution of the securities, or the terms and conditions related thereto, are unfair or unreasonable"; among the arrangements considered to be per se "unfair or unreasonable" is any right of first refusal to underwrite or participate in future public offerings, private placements or other financings which (A) has a duration of more than three years; or (B) provides more than one opportunity to waive or terminate the right of first refusal in consideration of any payment or fee.

2. In a Letter to the NASD, dated October 21, 2002, the Association of the Bar of the City of New York (a) reaffirmed its views on the applicability of the Anti-tying Statute (including that, under the right circumstances, a tie between a loan and a takeout of the loan would not constitute a prohibited tie), (b) challenged the NASD Tying Notice as inconsistent with functional regulation, and (c) challenged the proposition that it is appropriate for the NASD to assert jurisdiction over an activity when a broker-dealer purportedly abets a violation of a law applicable to an affiliate without a rulemaking process.

II. Operational Risk from a Capital Markets/Legal and Compliance Perspective

Operational risk has become an increasingly critical component of the risk management process for financial institutions. The Board Study Capital and Risk: New Evidence on Implications of Large Operational Losses (September 2003) underscores that (A) operational losses are such an important source of risk that the capital charge for operational risk will often exceed the charge for market risk, and

(B) financial institutions with better than average risk controls may reduce the likelihood of very large operational losses across business lines.[18]

A. Nature of "Operational Risk"[19]

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

a. Operational Risk losses are characterized by event factors associated with, among other things (i) internal fraud (an

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18 See also Guide to Bank Underwriting at Part II.A.

19 For recent background and discussion of Operational Risk see, e.g., Towards Greater Financial Stability: A Private Sector Perspective (Counterparty Risk Management Policy Group, July, 2005); Protecting the Brand: The Evolving Role of the Compliance Function and the Challenge for the Next Decade (PricewaterhouseCoopers, May 2005); Compliance and the Compliance Function in Banks (Basel Committee on Banking Supervision (the "Basel Committee"), April 2005); NASD Notice to Members 05-29 (April 2005) (guidance on the implementation of NASD supervisory controls); Federal Financial Institutions Examination Council Loss Data Collection Exercise (November 8, 2004); Uncertainty Tamed: The Evolution of Risk Management in the Financial Services Industry (PricewaterhouseCoopers, August 2004); Principles for the Home-host Recognition of AMA [Advanced Measurement Approach] Operational Risk Capital (Basel Committee, January 2004); The Oldest Tale but the Newest Story: Operational Risk (Fitch Ratings Special Report, January 7, 2004); Basel II -- A Closer Look: Managing Operational Risk (KPMG, 2003); Draft Supervisory Guidance on Operational Risk Advanced Measurement Approach for Regulatory Capital, 68 Fed. Reg. 45977 (August 4, 2003) (solicitation of public comments).

intentional act intended to defraud, misappropriate property or circumvent the law or bank policy); (ii) external fraud; (iii) employment practices (e.g., an act inconsistent with employment, health or safety laws or agreements or a diversity/discrimination event); (iv) clients, products and business practices (an unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements)); (v) damage to physical assets (natural disaster or other events); (vi) business disruption and system failures; or (vii) failed execution, delivery and process management.

b. Operational Risk is a broader concept than "operations" or back office risk. It encompasses risk inherent in business activities across a financial institution -- including in wide-ranging business lines such as (i) corporate finance, (ii) trading and sales, (iii) retail banking, (iv) commercial banking, (v) payment and settlement, (vi) agency services, (vii) asset management, and (viii) retail brokerage -- and, consequently, operational losses have the potential to be of great magnitude. A key fear is that of the "fat tail" result: occurrence of an event is rare, but the effects disproportionately damaging.

c. Reputational Risk is receiving increasing attention, and 84% of executives surveyed by the Economist in 2005 believe that the threat to their companies' reputations has increased significantly over the past five years and that compliance failures are the biggest source of reputational risk.[20]

2. Since Basel II resolves the debate between "Pillar 1" or "Pillar 2" treatment of Operational Risk in favor of "Pillar 1", Operational Risk will need to receive the same rigor of analysis, governance and risk management processes as are employed with respect to Credit and Market Risks.

[20] See Reputation: Risk of Risks (Economist Intelligence Unit, December 2005).

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

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

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

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

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

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

4. <u>Reconciliation of Regulatory Overlap for the Management and Supervision of Operational Risk in U.S. Financial Institutions</u> (Financial Services Roundtable, May 20, 2005) concludes that a close review of applicable banking and securities laws -- including the Federal Deposit Insurance Corporation Improvements Act (FDICIA), the GLBA, the Sarbanes-Oxley Act, and the Basel Committee's Advanced Measurement Approach with respect to Operational Risk capital charges, reveals certain common principles, including:

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

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

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

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

   e. An increased need for operational risk data collection and quantitative processes.

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

B. <u>Role of the Legal and Compliance Function in Respect of Operational Risk: Capital Markets Perspective</u>

1. Management of legal, compliance, strategic and reputational risks is a critical component of an Operational Risk control framework. Regulators expect that the legal and compliance function in financial institutions will be <u>vigilant</u> and <u>proactive</u> in assisting in the identification, monitoring and mitigation of these risks.

2. There is a key relationship between risks and controls. While legal and compliance personnel cannot be expected to implement various structural approaches, their role in monitoring corporate reporting systems, documenting appropriate policies and procedures, and training, educating and advising front, middle and back office personnel on risk management requirements is critical.

3. As a starting point, a financial institution must implement:

    a. A formal policy to address tolerance for legal, operational, compliance and reputational risks, including regular assessments of risk tolerance by senior management and procedures for escalating risk concerns to appropriate levels of senior management.

    b. 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.).

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

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 in this context) are:

a. Attention from the board of directors and senior management.[21]

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. Procedures for prompt redress of reporting problems.

e. Cooperation with regulators.

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

g. Limitations on outsourcing the compliance function.

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

a. Compliance problems are allowed to fester.

b. Conflicts of interest are not pursued and addressed.

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

d. BSA requirements (including, in particular, those respecting suspicious activity reports ("SARS")) are neglected.

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

[21] See generally KeyBank, OCC Consent Order No. 2005-141 (October 17, 2005) (citing board of directors' responsibilities in context of Bank Secrecy Act ("BSA") and related compliance 35 times).

C. Complex Structured Finance Transactions

1. The use of derivatives and other complex structured finance transactions, and the role of banks and other financial institutions in structuring these transactions for customers, have come under scrutiny in the wake of the Enron bankruptcy and related regulatory actions and litigation. These actions and proceedings show an increased willingness on the part of courts and regulators to hold financial institutions responsible for participating in transactions that may be deceptive or improperly reported.[22]

2. The proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. 28980 (May 19, 2004) (solicitation of public comments) (the "Proposed Interagency Statement") reflects in certain respects the requirements imposed under the regulatory actions against individual financial institutions in the wake of the Enron bankruptcy.

   a. Under the Proposed Interagency Statement each financial institution would be expected to develop:

      (i) Policies that:

         (A) Define the approval and control process for complex structured finance transactions.

         (B) Ensure that the reputational and legal risks associated with such a transaction are identified and evaluated in both the transaction and new product approval process and appropriately managed.

         (C) Ensure appropriate review and documentation of a customer's proposed accounting treatment of such a transaction, financial disclosures relating to such transaction, and business objectives.

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

(D) Provide for the generation, collection and retention of appropriate documentation.

(E) Ensure that senior management and the board of directors receive appropriate and timely reports concerning such activities.

(F) Provide for periodic independent reviews and internal audits of such activities to ensure that the institution's policies and controls are implemented effectively, and to identify potential compliance issues.

(G) Provide for appropriate training.

(ii) A risk management framework and comprehensive, institution-wide policies with respect to transactions which might involve higher legal or reputational risks, including a requirement, in instances that present heightened risk, that appropriate senior management review the customer's business relationship with the financial institution.

(iii) Board of directors/management determination of risk tolerance (including an unambiguous institution-wide culture of compliance which emphasizes the importance of integrity, compliance with law and business ethics), a methodology for identifying, evaluating and controlling applicable risks, and clear "new product" approval policies.[23]

(iv) A framework for transaction approval, including "escalation criteria" with respect to higher risk transactions which should trigger a more intensive

[23] See also OCC Bulletin No. 2004-20 (May 10, 2004): Risk Management of New, Expanded or Modified Bank Products or Services.

review. "Higher risk transactions" could involve such matters as:

(A) Questionable economic substance or business purpose, or features designed primarily to obtain a particular accounting or financial disclosure treatment, or a particular accounting, regulatory, legal or tax result.

(B) Concerns about how the client will report or disclose the transaction.

(C) Terms inconsistent with market norms (e.g., "deep in the money" options, non-standard settlement dates, non-standard forward-rate rolls).

(D) Legal agreements that deviate from market norms.

(E) Oral or undocumented agreements

(F) Multiple obligors, or multiple parts which are not fully described in a single agreement or offering document or which otherwise lack transparency.

(G) Multiple geographic or regulatory jurisdictions.

(H) Unusual profits, losses or compensation that appears disproportionate to the services provided or to the risk assumed (e.g., where the financial institution performs purely an "accommodation" role, without contributing economic substance to the transaction), or that may raise "appropriateness" or "suitability" considerations insofar as marketing to, or selection of, counterparties is concerned.

(I) Unusually short time horizons or potentially circular transfers of risk.

(J) An equity capital commitment.

(K) Significant leverage.[24]

b. Comments on the Proposed Interagency Statement have focused on such matters as (i) the responsibility that the Statement appears to place on a financial institution to oversee its client's intentions and state of knowledge, (ii) the Statement's "prescriptiveness", (iii) the proper application of the Statement in the context of multinational transactions and institutions; (iv) the need for clarity as to the Statement's scope; (v) the need to distinguish among the roles that financial institutions play in complex structured finance transactions (ranging from financial adviser to arm's length provider of services); (vi) the risk of the possible creation of new obligations, or increased legal risk not present in current law; and (vii) the creation of new procedural requirements not clearly calibrated to the degree of risk potential for abuse or materiality of a particular transaction.

c. It is expected that, in final form, the Proposed Interagency Statement will be substantially revised in response to the comments received.

d. In a Letter to Chief Executives, dated November 10, 2005 (the "FSA 2005 Letter"), the U.K. Financial Services Authority (the "FSA") set out its view as to senior management responsibilities to implement appropriate processes and procedures for the effective management of risks arising from non-standard structured finance transactions, and advised that "best practices" with respect to non-standard transactions include:

[24] See also FSA 2005 Letter (defined below) for identification of additional structured finance transactions which could raise "red flags" and thus be of higher risk.

(i) Written policies and procedures for managing transactions subject to heightened legal and reputational risk.

(ii) Policies and procedures to identify transaction characteristics that make it likely that the "front office" should escalate the transaction for approval by senior management.

(iii) Review of non-standard transactions by a senior and independent practitioner prior to execution, and senior management arrangements for the oversight of such transactions.

(iv) A culture of compliance with the spirit and intent of processes for non-standard transactions.

(v) A "front office" which is proactive in escalating transactions for senior review, and takes ownership of reputational risk management.

(vi) Adequate transactional documentation, with transparency on the nature of the risks being run, and a record of how the firm reached a decision on the transaction.

(vii) Controls to insure that where transactions are approved subject to conditions, there is adequate follow-up with respect to these conditions.

(viii) Processes that confirm that the end-to-end process is being following.

3. Another area of recent focus with respect to structured finance transactions are the SEC/N.Y. Attorney General inquiries relating to so-called "non-traditional insurance products", particularly reinsurance contracts with offshore reinsurers and products which are

intended either to smooth a counterparty's earnings or enhance its balance sheet.[25]

4. A number of principles arise from various Enron-related settlements with financial institutions and the Proposed Interagency Statement:

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

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

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

[25] See e.g., N.Y. v. American International Group ("AIG"), Docket No. 401720/05 (complaint) (Sup. Ct. N.Y. Co., May 26, 2005) (allegations that AIG disguised loans as reinsurance, inflating its reserves); SEC Litigation Releases No. 18985 (Nov. 30, 2004), No. 18340 (Sept. 11, 2003) (settlement of allegations that AIG arranged fraudulent reinsurance transactions for PNC Financial and Brightpoint).

d. In an apparent divergence from the position which U.S. bank regulators have taken with respect to the responsibility of a financial intermediary in respect of a counterparty to derivative transactions, the Proposed Interagency Statement appears to contemplate that a financial intermediary may need to be its "brother's keeper" in the context of complex structured finance transactions in a number of ways:

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

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

(ii) It will not be enough to assure securities law compliance that a transaction is recorded in accordance with generally accepted accounting principles ("GAAP") if its effect is to present an artificial depiction of a company's financial condition. Finding GAAP, therefore, does not fully answer the question as to the propriety of the applicable disclosures.

(iii) Lawyers who advise on, or assist financial institutions in structuring, a complex transaction may have an obligation to satisfy themselves as to the bona fides of the transaction. The "mere scrivener" standard will simply not apply, nor will it satisfy appropriate standards simply to be a "slave to a checklist". Senior legal and compliance personnel (or senior management

not involved in the implementation of the transaction or supervision of the relevant business unit) should approve the structure of a transaction. It will be important to focus on what a transaction is trying to accomplish (with special attention to conflicts of interest) in evaluating its propriety.

e. In terms of the potential liability of a financial intermediary for legal violations by counterparties in the context of complex structured finance transactions, there are two possibilities: an intermediary can become secondarily liable by taking actions which "aid and abet" the violation, or it can be so involved that it becomes primarily liable as a principal.[26]

(i) In general, there is no private right of action based on "aiding and abetting" theories. This does not preclude SEC action, however, under circumstances where there is (A) a violation by another party, (B) a general awareness or knowledge by the aider and abettor that its actions are part of an overall course of conduct that is improper, and (C) substantial assistance by the aider and abettor in the violative conduct.

(ii) Cases against financial institutions for primary liability can occur if the conduct of the intermediary -- including structuring, packaging, or executing the fraudulent transactions -- goes beyond mere general awareness and assistance to the primary violator.

(iii) If a financial intermediary is a public company and an attorney representing the company becomes aware of potential liability like that described, the SEC's

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[26] See, e.g., Board Supervisory Letter SR 04-7 (May 14, 2004), CCH Fed. Banking L. Rep. ¶ 62-164 ("SEC Guidance on the Potential Liability of Financial Institutions for Securities Law Violations Arising from Deceptive Structured Finance Products and Transactions").

"reporting up" rules under Section 307 of the Sarbanes-Oxley Act could apply.[27]

D. Other Key Current Legal and Compliance Issues[28]

1. Responsibility for (a) building a "culture of compliance", (b) assuring compliance with "best" operational, ethical and business practices,

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[27] See generally Cleary Gottlieb Steen & Hamilton LLP, The Sarbanes-Oxley Act: Analysis and Practice (Aspen Publishers, 2003).

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

This Outline is not intended, however, to address (i) all legal requirements applicable to the operation of a bank or broker-dealer (e.g., requirements with respect to broker-dealer registration as an investment adviser (and vice versa), books and records, account documentation, "free riding and withholding", "market-timing"/"late trading"/"analyst conflicts of interest", margin (or other) lending, business continuity planning, branch office supervision, custody/control, etc.); (ii) legal requirements which are not expected to be applicable until later in 2006 (e.g., SEC "broker push-out rules"); or (iii) front/back office business line-related risk management processes and procedures, lending/investment issues, capital-related issues, derivatives/foreign exchange transactional issues, or similar areas that would not primarily represent a legal/compliance responsibility.

For recent analyses of the compliance function in securities firms (including comments on the specific role and aspects of the compliance function), see, e.g., White Paper on the Role of Compliance (Securities Industry Association ("SIA"), October 2005); "The Costs of Compliance in the U.S. Securities Industry", SIA Research Reports (August 31, 2005).

and (c) implementing effective codes of conduct.[29]

2. Recognition of the principal areas which generate reputational risk, including those arising from:

   a. Participation in tax-, accounting-, or regulatory avoidance-driven transactions, or novel, complex or unusually profitable transactions that may raise "appropriateness" or "suitability" considerations insofar as marketing to, or selection of, counterparties is concerned.

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

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

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

3. Focus on identification and resolution of conflicts of interest that arise (a) between the financial institution and its customers, (b) among the financial institution's customers, and (c) among different business units of the same financial institution. Conflicts of interest which arise from multiple relationships with a customer (e.g., lender, equity investor, advisor, board representative) may require special attention so that the potentially increased risk of equitable subordination,

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

incurring fiduciary obligations, additional restrictions on information-sharing, etc., can be addressed.[30]

4. Focus on compliance with restrictions on affiliate transactions, in particular, under Sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.[31]

   a. Sections 23A/23B are the main constraint on transactions between FHC/BHC securities firms and their bank affiliates. As the activities of non-bank subsidiaries have expanded, and

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[30] See, e.g., FSA 2005 Letter, which sets out the FSA's view of the characteristics of a "well-managed firm" in respect of conflict of interest concerns, including the following:

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

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

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

(iv) senior management is involved in the process overall;

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

(vi) the culture of the firm supports effective management of conflicts of interest; and

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

See also Part II. D.12.b.(i) below.

[31] 12 U.S.C. §§ 371c, 371c-1 ("Sections 23A/23B"); 12 C.F.R. Part 223. See Bank Activities Guide at Part III.A.6.

regulatory restrictions have been reduced, the importance of Sections 23A/23B has increased.

(i) Among other things, Section 23A limits a bank's "covered transactions" (including credit extensions and purchases of assets) with an "affiliate" to 10% (and with all "affiliates" combined to 20%) of the bank's capital and surplus, and imposes collateralization requirements on any extension of credit to an affiliate by a bank.

(ii) Among other things, Section 23B subjects all transactions between a bank and its affiliates to a requirement that such transactions be at least as favorable to the bank as those prevailing at the time for comparable transactions involving unaffiliated companies (the "Market Terms Requirement").

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

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

(ii) Satisfaction of the requirements for exemption from Section 23A of intraday extensions of credit by a bank to its affiliate (12 C.F.R. § 223.42(l)) that the bank (A) establish and maintain policies reasonably designed to manage the credit exposure arising from such credit extensions in a safe and sound manner (including policies for (1) monitoring and controlling the credit exposure from the bank's intraday extensions of credit to each affiliate and all affiliates in the aggregate, and (2) ensuring that any intraday extension of credit by the bank to an affiliate complies with the Market Terms Requirement; (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 comply with the Market Terms Requirement.

(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.[32]

(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.

[32] See Board Letter to Bank of America, dated June 7, 2005.

(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).[33]

5. Focus on compliance with the Anti-tying Statute.[34]

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

a. U.S. federal banking authority being relied upon for such investment;[35] e.g.:

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

(ii) Treatment of merchant banking-type investments in financial services businesses (including such entities as banks/BHCs, savings associations/thrift holding companies, foreign banks with U.S. operations, industrial banks, non-bank banks, credit unions, mortgage/consumer/commercial finance companies, broker-dealers, investment advisers/asset managers, commodity pool operators, futures commission

33 See Bank Activities Guide at Part VIII.B.1.c.viii. See also Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates (January 5, 2004).

34 See Part I above.

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

merchants, money transmitters, check cashing operations, insurance companies, trust companies).[36]

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

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

(v) BHCA §§ 4(c)(6)/4(c)(7): "passive," "non-controlling" investments in not more than 5% of any "class" of "voting securities", and less than 25% of the "equity", of a portfolio company ("4(c)(6) Investments"), or investments in an "investment company" limited to investments in debt "securities" and/or 4(c)(6) Investments.

(vi) The Board's Regulation K: investments in certain foreign companies exclusively (or predominantly) engaged in business outside the United States.

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

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

c. Compliance with regulatory requirements applicable to the inter-relation between equity investments and other banking

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

laws (e.g., Sections 23A/23B, the Anti-tying Statute, "cross-marketing" restrictions, reporting requirements, etc.).

7. Identification and monitoring of key risk indicators with respect to derivatives transactions and other trading activities,[37] including:

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

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

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

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

8. Evaluation of issues with respect to the identification and treatment of material non-public information in the context of loan, credit derivative and related markets, as well as in the context of "traditional" securities trading.[38]

[37] See Bank Activities Guide at Part II.E.

[38] See Bank Activities Guide at Part V.A.3.d. See also, e.g., 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).

9. Review/evaluation of outsourcing contracts.[39]

10. Focus on compliance with banking and securities law requirements in connection with international securities transactions/linkages,[40] in terms of (a) licensing,[41] and (b) supervision.[42]

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[39] See, e.g., NASD Notice to Members 05-48 (July 2005) (broker-dealer due diligence and supervisory responsibilities when outsourcing activities to third-party service providers, and prohibition on outsourcing activities requiring registration or qualification, or supervisory or compliance responsibilities); New York Stock Exchange ("NYSE") proposed Rule 340 (see SEC Release No. 34-51240 (March 16, 2005) (solicitation of public comments) (procedures with respect to the outsourcing of services and functions by NYSE members)); Basel Committee/International Organization of Securities Commissions ("IOSCO")/International Association of Insurance Supervisors Report: Outsourcing in Financial Services (February 2005). See also Bank Activities Guide at Part I.B.6.f and Part IX.B.2.

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

[41] See, e.g., CIBC Mellon Trust, SEC Admin. Proc. No. 3-11839 (March 2, 2005) (settled administrative action against CIBC Mellon Trust for failing to register as a transfer agent or as a broker-dealer in connection with its activities as administrator of employee stock plans for issuers for which CIBC Mellon acted as transfer agent); SEC v. CIBC Mellon Trust, SEC Litigation Release No. 19081 (February 16, 2005) (charge of employee participation in fraudulent scheme to promote, sell and distribute stock of non-U.S. company through illegal issuance of stock certificates; CIBC Mellon charged with having failed to train its employees with respect to U.S. securities laws, or create systems to assure compliance with U.S. securities laws despite providing transfer agent services to U.S. publicly-traded companies).

[42] See, e.g., CSFB, SEC Admin. Proc. No. 19081 (February 16, 2005) (failure (i) to supervise an employee who engaged in improper trading on behalf of a non-U.S. subsidiary which CSFB failed to detect since the employee's only supervisor was an employee of the non-U.S. subsidiary located outside of the U.S., and was not properly licensed as a supervisor at CSFB; and (ii) to establish systems to implement supervisory procedures to track and monitor supervisory appointments to ensure that all registered representatives in the U.S. were assigned to a properly licensed supervisor).

11. Focus on compliance with the USA PATRIOT Act and the BSA, including in respect of SAR filing and implementation of adequate know-your-customer procedures.[43]

12. Sensitivity to special concerns relating to broker-dealer/investment adviser and related compliance responsibilities.[44]

    a. Compliance with the SEC's "Dealer Push-out Rules", which limit the activities of U.S. banks, as principal, involving certain securities.[45] These Rules became effective on October 1, 2003 (although the SEC adopted an exemption for contracts entered into before March 31, 2005 from being considered void or voidable by reason of a violation of broker-dealer registration requirements based solely on the bank's status as a dealer when the contract was created).[46]

    b. Top areas of interest for current SEC/NASD broker-dealer examinations include:[47]

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43 See, e.g., Oppenheimer & Co., NYSE Hearing Panel Decision 05-181 (December 29, 2005) (failure to establish an adequate anti-money laundering compliance program and failure to establish and implement policies and controls designed to achieve compliance with the BSA); Bush & Carroll, "Suspicious Activity Reporting: Recent Developments and Guidance on Key Issues", Review of Banking & Financial Services (November 2005). See also Bank Activities Guide at Part VIII.A.

44 See Bank Activities Guide at Part IX.E.

45 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.

46 See 1934 Act Rule 15a-8.

47 See, e.g., Remarks of SEC Office of Compliance Inspection and Examinations Associate Director Gohlke, November 14, 2005; Remarks of SEC Office of Compliance Inspections and Examinations Associate Director Gadziala, October 19, 2005, June 23, 2005. See also, SEC Release No. 2006-4 (January 4, 2006) (framework for determining whether, and if so to what extent, to impose civil penalties against a corporation); SEC Litigation Release No. 19517 (January 3, 2006)
(fn. cont.)

(i) 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, (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).

(ii) 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 mutual funds and variable annuities.

(iii) Trading and pricing practices (including best execution).

(fn. cont.)

(SEC action against former officers of Putnam Fiduciary Trust Company for fraudulent activity; SEC announcement that it would not bring any enforcement action against the Trust Company "because of its swift, extensive and extraordinary cooperation in the [SEC]'s investigation of the [subject] transactions [including] . . . prompt self-reporting, an independent internal investigation, sharing the results of that investigation with the government (including not asserting any applicable privileges and protections with respect to written materials furnished to the [SEC] staff), terminating and otherwise disciplining responsible wrongdoers, providing full restitution to its defrauded clients, paying for the attorneys' and consultants' fees of its defrauded clients, and implementing new controls designed to prevent the occurrence of fraudulent conduct").

(iv) Supervision and compliance (including capital compliance and compliance with anti-money laundering requirements, etc.).[48]

(v) Creating and marketing structured finance products.[49]

(vi) Internal controls (including risk management and separation of banking from research) and books and records.

(vii) Procedures to prevent misappropriation of customer assets.

(viii) Mark-ups (e.g., on corporate and municipal bonds).

(ix) Information security.

c. In seeking to assure a quality compliance program, in his Remarks of June 21, 2005, NYSE Chief Regulatory Officer Ketchum said that it is critical that firms' legal and compliance officers regularly work through a series of tough questions, including:

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48 See, e.g., Oppenheimer & Co., NYSE Hearing Panel Decision 05-190 (December 29, 2005) (failure to supervise and control various business activities, including failure to notify the NYSE immediately upon discovery of conditions which it reasonably should have believed could lead to capital problems, operational problems, impairment of recordkeeping, and/or impairment of control functions). See also note 41 above.

49 See, e.g., NASD Notice to Members 05-59 (September 2005) (guidance concerning the sale of structure products, including in respect of (i) promotion of structured products, (ii) eligible accounts, (iii) suitability and fair dealing with customers, (iv) supervision and supervisory control systems, and (v) training). See also Part II.C above.

(i) Whether the access of senior legal and compliance personnel is regular and systematic, or ad hoc and episodic.

(ii) Even if access is regular, whether it involves a full analysis of compliance developments and exposures, or is cursory.

(iii) Whether the firm's commitment to providing technology resources is as great for compliance as it is for other initiatives.

(iv) Whether the firm has analyzed compliance technology proposals that did not receive approval in prior budgets to see if exposures are still there.

(v) Whether areas such as fixed income, stock loan and operations have received the same level of compliance attention as equity and investment banking.

(vi) Whether employees are truly rewarded for raising what they perceive as compliance issues.[50]

d. With respect to investment advisers/investment companies:

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[50] See also NYSE Information Memos No. 05-77 (October 7, 2005) (factors considered by the NYSE Division of Enforcement in determining sanctions for violations of statutes, regulations or rules; heightened penalties could arise as a result of failure to implement corrective measures, neglect or disregard of "red flags" and ineffective training or education programs), No. 05-65 (September 14, 2005) (guidance on obligations to cooperate with NYSE reviews, examinations and investigations, and to provide disclosure to the NYSE of violations of NYSE rules or federal securities laws; discussion of "exceptional or extraordinary cooperation" that has the potential to influence the NYSE to seek a reduced sanction, to decide to bring reduced or less serious charges, to obviate the need for an undertaking, or to decide to forgo bringing charges altogether); Wall Street Letter, December 19, 2005 (NYSE focus on physical separation between proprietary trading and stock trading desks).

(i) Recent areas of compliance interest[51] include:

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

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

(C) Suitability.

(D) Information controls to prevent insider trading and front running.

(E) Anti-money laundering compliance.[52]

(F) Fund shareholder trading ("market timing", "late trading", etc.).[53]

(G) Transactions with affiliates (including favoritism, abusive/undisclosed transactions,

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51 See, e.g., Remarks of SEC Office of Compliance Inspection and Examinations Director Richards, December 23, 2005; Remarks of SEC Office of Compliance Inspection and Examinations Associate Director Gohlke, December 6, 2005; Remarks of SEC Division of Investment Management Director Roye, January 25, 2005. Compare Assessing the Adequacy and Effectiveness of a Fund's Compliance Policies and Procedures (Investment Company Institute, December 2005).

52 See generally Anti-money Laundering Guidance for Collective Investment Schemes (IOSCO, October 2005).

53 See generally Oppenheimer & Co., NASD News Release, January 9, 2006 (charge of knowingly submitting inaccurate and incomplete data in response to NASD request for self-assessment of mutual fund breakpoint discount practices); Best Practices Standards on Anti-market Timing and Associated Issues for CIS [Collective Investment Schemes] (IOSCO, October 2005).

and payments involving use of client assets).[54]

(H) Personal trading issues.

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

(J) Advertising and performance claims.

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

(L) Book and record maintenance.

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

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

(ii) In his Remarks of May 5, 2005, SEC Office of Compliance Inspections Associate Director Gohlke recommended the following duties and functions, among others, for chief compliance officers of an investment adviser:

(A) Advises senior management on the fundamental importance of establishing and maintaining an effective culture of compliance.

[54] See, e.g., U.S. Bank, SEC Admin. Proc. No. 3-12029 (September 2, 2005) (settlement of cease-and-desist proceedings against U.S. Bank, which (i) engaged as principal in $7 billion in prohibited foreign exchange transactions with investment companies advised by a U.S. Bank subsidiary, and (ii) did not have adequate compliance procedures and controls designed to prevent affiliated transactions with such investment companies).

(B) Confers with and advises senior management on significant compliance matters and issues, ensures that there is timely and appropriate review of material and repetitive compliance issues as indicators of possible weaknesses in policies or risk identification processes, and facilitates the use of such information in keeping the adviser compliance program evergreen.

(C) Provides "consulting" to business people throughout the adviser regarding compliance matters and issues and becomes involved in analyzing and resolving significant compliance issues.

(D) Ensures that the steps in the adviser's compliance process -- risk identification, establishing and implementing policies -- are appropriate and are undertaken timely; and ensures that appropriate principles of management and control are observed in policy implementation (including separation of functions, clear assignment of responsibilities, measuring results against standards, reporting outcomes and regular reviews).

(E) Ensures that compliance policies are comprehensive, robust and current, and reflect the adviser's business processes and conflicts of interest; and manages the compliance unit in ways that encourage pro-active work, professional skepticism, and "thinking outside the box" by compliance staff.

(F) Ensures that quality control (transactional) testing is conducted as appropriate to detect deviations of actual transactions from policies or standards, and that results of such tests are included on exception and other management

reports and are promptly addressed, escalated when necessary, and resolved by responsible business people.

(G) Undertakes periodic analyses and evaluation of compliance issues found in the regular course, together with the results of appropriate forensic testing conducted by compliance staff as a means for obtaining evidence regarding both the effective functions of the adviser's compliance program and the possible existence of compliance issues.

(H) Ensures that compliance programs of service providers used by the adviser are effective so that the services provided are consistent with the adviser's fiduciary obligations.

(I) Establishes a compliance calendar that identifies all important dates by which regulatory, client reporting, tax and compliance matters must be completed.

(J) Promotes a process for regularly mapping the adviser's compliance policies and conflicts of interest to disclosures made to clients, so that disclosures are current, complete and informative.

(K) Manages the adviser's code of ethics.

(L) Is a strong advocate for allocating appropriate resources to the development and maintenance of an effective compliance program.

(M) Recognizes the need to remain current on regulatory and compliance issues, participates in continuing education programs, and ensures that staff is appropriately trained in compliance-related matters.

(iii) NASAA News Release, September 13, 2005, recommended best practices for investment advisers to improve their compliance practices and procedures, including (A) reviewing and revising Form ADV/disclosure brochure to reflect current and accurate information, (B) reviewing and updating advisory contracts, (C) maintaining a written supervisory procedures manual, (D) preparing and

(iv) regularly distributing a privacy policy, (E) accurate recordkeeping, (F) maintaining any required surety bond, (G) preparing and maintaining client profiles, (H) calculating and documenting fees correctly, (I) reviewing and revising advertisements, and (J) implementing custody safeguards.

Robert L. Tortoriello
CLEARY GOTTLIEB STEEN & HAMILTON LLP
Tel. No.: 212-225-2390
Fax No.: 212-225-3999
E-mail: rtortoriello@cgsh.com

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1.212.225.2000
1.212.225.3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1.202.974.1500
1.202.974.1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33.1.40.74.68.00
33.1.45.63.66.37 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32.2.287.2000
32.2.231.1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44.20.7614.2200
44.20.7600.1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7.501.258.5006
7.501.258.5011 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49.69.97103.0
49.69.97103.199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49.221.80040.0
49.221.80040.199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39.06.695.221
39.06.69.20.06.65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39.02.72.60.81
39.02.86.98.44.40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852.2521.4122
852.2845.9026 Fax

TOKYO
Shin-Kasumigaseki Building, 20th Floor
3-2, Kasumigaseki 3-chome
Chiyoda-ku, Tokyo 100-0013, Japan
81.3.3595.3911
81.3.3595.3910 Fax