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SIFMA COMPLIANCE AND LEGAL DIVISION ANNUAL SEMINAR

# SECURITIES ACTIVITIES OF BANKS IN THE GLB ERA: COMPLEX STRUCTURED FINANCE AND OPERATIONAL RISK ISSUES[1]

Phoenix, Arizona
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This Outline is intended to address (I) recent guidance and developments in respect of complex structured finance transactions; and (II) recent issues and precedents with respect to operational risk management in the capital markets context from a legal and compliance perspective.

## I. Complex Structured Finance Transactions

A. 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.[2]

B. The Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities (the "Final Interagency Statement on CSFTs"), 72 Fed. Reg. 1372 (January 11, 2007) (the "Interagency Statement Release") -- adopted by the Federal Reserve Board (the "Board"), the Office

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1 Many of the matters discussed in this Outline (which is current as of January 15, 2007), 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 & Glotzer, Guide to Bank Underwriting, Dealing and Brokerage Activities (Thomson LegalWorks, 11th ed., 2006) (the "Bank Activities Guide").

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

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of the Comptroller of the Currency (the "OCC"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of Thrift Supervision (the "OTS") and the Securities and Exchange Commission (the "SEC") -- offers principles-based guidance to banks and other financial institutions with respect to their involvement in complex structured finance transactions ("CSFTs"). The SEC has adopted the Final Statement as a policy statement, and the Board/Comptroller/FDIC/OTS have adopted it as supervisory guidance.[3]

1. The process that led to the issuance of the Final Interagency Statement on CSFTs began with a Proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. 28980 (May 19, 2004) (the "Initial Proposed Interagency Statement on CSFTs"), which was part of the regulatory response to actions against financial institutions in the wake of the Enron bankruptcy, and was carried forward in a Revised Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 71 Fed. Reg. 28386 (May 16, 2006) (the "Revised Proposed Interagency Statement on CSFTs"), which was put out for further public comment.

2. The Revised Proposed Interagency Statement on CSFTs modified the Initial Proposed Interagency Statement on CSFTs to make the Statement more principles-based and focused on the identification, review and approval process for those CSFTs that may pose heightened levels of legal or reputational risk ("elevated risk CSFTs"). The Final Interagency Statement on CSFTs made minor modifications to the Revised Proposed Statement designed to clarify,

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[3] See also National Association of Securities Dealers ("NASD") Notice to Members 05-59 (September 2005) (NASD guidance to its members in respect of the sale and trading of structured finance products to the effect that such members are obliged to (i) provide balanced disclosure in promotional efforts, (ii) ascertain whether CSFTs are appropriate for the relevant accounts, (iii) deal fairly with customers when making recommendations or accepting orders, (iv) perform suitability determinations, (v) maintain a supervisory control system, and (vi) implement adequate training; failure to comply with these obligations, particularly when selling structured products to retail or unsophisticated investors, may result in NASD disciplinary action).

but not alter, the principles set forth in the Revised Proposed Statement. The Final Statement also describes some of the internal controls and risk management procedures that may help financial institutions identify, manage and address the heightened reputational and legal risks that may arise from elevated risk CSFTs.

3. The Final Interagency Statement on CSFTs focuses on the identification and management of elevated risk CSFTs based on the following principles and recommendations:

   a. Identification of elevated risk CSFTs.

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

         (A) Lack economic substance or business purpose.

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

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

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

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

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

         (G) Provide the financial institution with compensation disproportionate to services, or

to the credit, market or operational risk assumed by the institution.

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

(iii) A financial institution operating in foreign jurisdictions may tailor its policies and procedures to account for the laws, regulations and standards of those jurisdictions. The Final Interagency Statement on CSFTs clarifies that a U.S. branch of a foreign bank is not necessarily expected to establish separate U.S.-based risk management structures or policies for its CSFT activities, and is intended to provide those branches sufficient flexibility to develop controls, risk management and reporting structures and lines of authority that are consistent with their internal management structure. However, it is expected that the risk management structure and policies used by a U.S. branch, whether adopted or implemented on a group-wide or stand-alone basis, should be effective in allowing the branch to manage the risks associated with its CSFT activities.[4]

[4] See generally Institute of International Bankers Comment Letter, dated June 15, 2006.

(iv) In terms of the type of transactions that should be characterized as elevated risk CSFTs:

(A) The Final Interagency Statement on CSFTs recognizes that structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured transactions -- such as standard public mortgage-backed securities and hedging-type transactions involving "plain vanilla" derivatives or collateralized debt obligations -- typically would not be considered CSFTs for purposes of the Final Statement.

(1) The Interagency Statement Release clarifies that the types of non-complex transactions listed in the Final Statement are only intended to be examples of the types of transactions that typically would not be considered CSFTs, and that such listing is not intended to be all-inclusive given the changing nature of the structured finance market.

(2) The hallmarks of a non-complex transaction are that it has a well-established track record and is familiar to participants in the financial markets.

(B) Some commenters contended that the examples of elevated risk CSFTs contained in the Final Interagency Statement on CSFTs have characteristics that are signals -- if not conclusive proof -- of fraudulent activity, and recommended that financial institutions be informed that transactions or products with any of these characteristics should be considered presumptively prohibited. However, the Final Statement reflects the view that, while CSFTs that initially appear to an institution, during the

ordinary course of its new product or transaction approval process, to have one or more of the identified characteristics should generally be identified as an elevated risk CSFT (and the institution should conduct due diligence for the transaction that is commensurate with the level of identified, potential risks), it is not appropriate to provide that all transactions initially identified as potentially creating elevated legal or reputational risks for an institution should be considered presumptively prohibited. Rather, if, after evaluating an elevated risk CSFT, a financial institution determines that its participation in the transaction would create risks, the institution should take appropriate steps to manage and address those risks (including modifying the transaction or conditioning the institution's participation in the transaction upon the receipt of representations or assurances from the customer that reasonably address the risks presented).

(C) The Final Interagency Statement on CSFTs does not necessarily prevent a financial institution from proceeding with a CSFT simply because there may be some ambiguity in how the transaction might be viewed under the law or applicable accounting principles. In certain circumstances, ambiguities may exist as to how the law or accounting principles apply to a CSFT, particularly in light of the inherent complexity and rapidly evolving nature of CSFTs. Nevertheless, as discussed in the Final Statement, a financial institution should maintain strong and effective processes and controls designed to determine whether any such ambiguities may create significant legal or

reputational risks and to manage and address those risks as appropriate.

b. Due diligence.

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

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

c. Approval process.

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

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

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

d. Documentation.

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

(A) Document the material terms of the transaction.

(B) Enforce the material obligations of counterparties.

(C) Confirm that customers have received any required disclosures concerning the transaction.

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

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

(iii) The provisions of the Final Interagency Statement on CSFTs regarding maintenance of documentation for elevated risk CSFTs submitted to an institution's senior management for approval (or disapproval) do not apply to transactions that may be reviewed and acted on by more junior personnel in accordance with

the institution's policies. Rather, these provisions apply only to those elevated risk CSFTs that are identified by the institution as potentially involving the greatest degree of risk and, for this reason, are required to be reviewed by senior management. Moreover, to help address commenters' concerns about the potential burden of maintaining such documentation, the Final Statement (A) recognizes that the minutes of an institution's reviewing senior management committee may have the information described; and (B) clarifies that, while the documentation should reflect the factors considered by senior management in taking action, it does not have to detail every aspect of the institution's legal or business analysis.

e. Other risk management principles.

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

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

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

(iv) Audit*:* Internal audit or an internal compliance function should regularly audit the financial institution's compliance with its policies (and the

adequacy of such policies related to elevated risk CSFTs). Periodic validations should include transaction testing. The Interagency Statement Release clarifies that an institution's audit or compliance department should have the flexibility, in appropriate circumstances, to review the decisions made by institution personnel during the review and approval process for elevated risk CSFTs, and not merely confirm that the institution's policies for elevated risk CSFTs are being followed.

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

4. Following adoption of the Final Interagency Statement on CSFTs, U.S. banking regulators have apparently moved away from their recent, prior position that every bank creation of subsidiaries in respect of CSFTs would require specific prior regulatory approval.

5. The Final Interagency Statement on CSFTs shortened, narrowed and substantially revised the Initial Proposed Interagency Statement on CSFTs in response to public comments.

a. Among the concerns raised by industry commenters with respect to the Initial Proposed Statement were (i) the "prescriptiveness" of such Statement; (ii) the potential for vagueness to generate compliance obligations or legal risk beyond the intended scope and purpose of such Statement, particularly with respect to CSFTs that have become "plain vanilla" after prolonged market exposure; and (iii) the need to distinguish among the roles that financial institutions play in CSFTs (ranging from financial adviser to arm's-length provider of services). In response, the Revised and Final Interagency Statements on CSFTs set out principles-based guidance that imposes few concrete procedural or compliance obligations, but instead enunciates the goals that banks' internal policies should achieve. The Final Statement's focus

on elevated risk CSFTs and recommendations with respect to differentiating them from more familiar, lower-risk CSFTs is part of this change in tone.

b. In response to industry comments on the Revised Proposed Interagency Statement on CSFTs requesting that the Statement clarify operational, compliance and documentation requirements and the legal standards governing the potential liability of financial institutions in respect of CSFTs,[5] the Interagency Release indicates that the Final Statement does not, by itself, (i) establish any legally enforceable requirements or obligations, (ii) create any private rights of action, or (iii) alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other parties under applicable law.

c. Some commenters were critical of the scope of the Revised Proposed Interagency Statement on CSFTs and questioned whether the Revised Statement provided sufficient preemptive guidance, or created the potential for financial institutions to aid and abet securities fraud.[6]

6. Following the issuance of the Final Interagency Statement on CSFTs, Senator Levin strongly objected to what he characterized as "much weaker final guidance than proposed in 2004" and complained about (a) a softening of language in the Final Statement, (b) deletion of a recommendation that the board of directors establish a policy on CSFT risk, (c) reduction of documentation requirements, and (d) language suggesting that financial institutions that do not design or market CSFTs (but merely facilitate or implement them) may have a reduced obligation to obtain information on the nature of the

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5 See, e.g., American Bankers Association/Bond Market Association/International Swaps Dealers Association/Securities Industry and Financial Markets Association ("SIFMA"), Bank of America and Clearing House Association Comment Letters, dated June 15, 2006.

6 See, e.g., Comment Letter of Professors Cohen, Dana, Koniak and Ross, dated June 2, 2006.

transaction. He concluded that Congress needs to watch very closely to see if the Final Statement results in weaker enforcement or an increase in structured finance abuse.[7]

C. In an Amicus Curiae Brief in Support of Appellees in Regents of the University of California et al. v. Credit Suisse et al., No. 06-20856 (5th Cir., January 5, 2007), 30 states have taken the side of Enron shareholders which are seeking damages from investment banks which allegedly participated in Enron's accounting fraud. The Brief supports the District Court determination (In re Enron Corp. Sec. Derivative & ERISA Litig., 2006 U.S. Dist. LEXIS 43146 (S.D. Tex. 2006)) that if an investment bank was a "substantial participant" in the fraud, it can be held liable for any of the unlawful acts taken by any of the participants in the scheme in which they participated, even if the investment bank did not itself make any false statement on which investors relied, and regardless of whether the conduct in question occurred prior to the bank's involvement in the transaction. On this theory, a scheme to defraud is a unitary violation, such that a plaintiff need not prove transaction causation with respect to any particular misrepresentations or omissions or other components of the scheme. Among the standards asserted as relating to conduct which constitutes a primary violation of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") and SEC Rule 10b-5 thereunder are the following:

1. If a third party and a corporation engage in a transaction whose principal purpose and effect is to create a false appearance of revenues, intended to deceive investors in that corporation's stock, the third party may be a primary violator.

2. If the parties to a transaction have a side oral agreement that no goods will be delivered and no money paid and the corporation falsely states that it received revenue from the transaction, the third party may be liable as a primary violator.

D. Hypo-und Vereinsbank ("HVB") entered into a Department of Justice Deferred Prosecution Agreement, dated February 13, 2006, admitting that it had assisted in the evasion of taxes on $1.8 billion in income by (1) participating in and implementing fraudulent tax shelters through

[7] News Release, dated January 5, 2007.

transactions purporting to be "loans" (but which were not bona fide loans); (2) participating in trading activity on instructions from promoters that was intended to create the appearance of investment activity but that had no real substance; and (3) participating in creating documentation that contained false representations concerning the purpose and design of the transactions. In addition to paying a $29 million fine, HVB agreed to (a) prohibit participation in any transaction or strategy that has a significant tax component, unless such transaction or strategy is accompanied by an opinion that the transaction "should" be upheld by the courts if litigated, and HVB independently concurs with that opinion; (b) adopt a new "transaction approval" process for loan officers that involves review and approval by its Tax Director of any transaction that has a significant tax component; (c) implement operational controls that prevent account officers from controlling banking transactions after the formal closing of the transactions; and (d) implement and maintain an effective compliance and ethics program.

E. "Non-traditional insurance products", particularly reinsurance contracts with offshore reinsurers, have come under scrutiny from the SEC and the state regulators. Most prominent in both investigations is American International Group ("AIG"), which entered into a Settlement Agreement with the SEC and the New York Attorney General under which AIG paid $800 million, consisting of disgorgement of $700 million and a penalty of $100 million, and undertook corporate reforms designed to prevent similar misconduct. The complaint alleged that AIG reinsurance transactions with General Re Corporation were designed to inflate AIG's loss reserves by $500 million in order to quell analyst criticism. The complaint also identified other transactions in which AIG allegedly misstated its financial results through sham transactions. Criminal charges have also been filed against certain executives.[8]

F. A number of principles arise from the Enron-related actions, similar judicial and administrative proceedings and the Final Interagency Statement on CSFTs.

[8] See SEC Litigation Release No. 19560 (February 9, 2006); New York v. AIG, Docket No. 401720/05 (amended complaint) (Sup. Ct. NY Co., September 7, 2006); Insurance Forum, May 2006.

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

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

3. A financial intermediary should:

   a. Establish policies, and a process, for review and consideration of any unusual or suspect transaction where a purpose is to achieve a particular economic, accounting, tax, legal or regulatory objective (including an objective to obtain off-balance sheet treatment, to counteract or delay the failure of another transaction, to replace debt with funds characterized as other than debt, or to characterize as something other than a financing what is, in fact, a loan);

   b. Be attentive to CSFTs that could create legal or reputational risks (including CSFTs whose only purpose is to have a financial statement impact).

   c. Conduct its review and diligence process in respect of elevated risk CSFTs through well-qualified accounting, legal, compliance and operational personnel.

   d. Assure that sufficient information is provided to the appropriate committee or senior management that addresses applicable risks, and the manner in which such risks are proposed to be addressed.

   e. Identify "red flags" (if any) for further review once a CSFT has been approved and consummated (e.g., early un-winds).

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

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

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

    b. Recording a CSFT in accordance with generally accepted accounting principles does not fully answer the question as to the propriety of the applicable disclosures.

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

## 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.

### A. Nature of "Operational Risk"[9]

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.

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[9] For recent regulatory and other background and discussion of Operational Risk see, e.g., Ludwig, "How to Minimize Risk of Tax-event Damage", American Banker, September 29, 2006; "Operational Risk", FDIC Supervisory Insights (Summer, 2006); Remarks of Board Governor Olson, May 16, 2006 (Compliance Risk Management in a Diversified Environment); Enhancing Corporate Governance for Banking Organizations (Basel Committee on Banking Supervision (the "Basel Committee"), February 2006); Sound Practices for Managing Legal Risk: Principles for Legal Departments in Financial Institutions (Federal Reserve Bank of New York ("FRBNY"), 2006); 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, April 2005); NASD Notice to Members 05-29 (April 2005) (guidance on the implementation of NASD supervisory controls); Federal Financial Institutions Principles for the Home-host Recognition of AMA [Advanced Measurement Approach] Operational Risk Capital (Basel Committee, January 2004); Draft Supervisory Guidance on Operational Risk Advanced Measurement Approach for Regulatory Capital, 68 Fed. Reg. 45977 (August 4, 2003) (solicitation of public comments).

a. Operational Risk losses are characterized by event factors associated with, among other things (i) internal fraud (an intentional act intended to defraud, misappropriate property or circumvent the law or bank policy); (ii) external fraud; (iii) employment practices (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. 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.[10]

2. Regulators have noted the increasing diversification of banks' lines of business, increased use of over-the-counter derivatives and other trading activities, increased use of outsourcing arrangements, and increased use of e-commerce, as sources of Operational Risk. Particularly in light of the Enron bankruptcy and related developments discussed in Part I above, and in light of the

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

implications of anticipated explicit capital charges for Operational Risk under the revised capital requirements of the Basel Accord (Basel II), regulators have increasingly focused on the need for internal policies, controls and procedures (including escalation to senior management, where appropriate) to manage Operational Risk.

3. The focus for Operational Risk management is shifting from a compliance model focused primarily on adherence to existing laws and regulations to one that targets more complete enterprise-wide risk management. This involves the legal and compliance functions in facilitating the creation of firm-wide values, evaluating firm-wide business practices, and constructing firm-specific "best practice" models.

   a. Observed Range of Practice in Key Elements of Advanced Measurement Approaches (Basel Committee, October 2006) (the "2006 Basel Report") describes specific practices that banks opting for the Advanced Measurement Approach in respect of capital requirements have adopted in their Operational Risk-related work in regard to internal governance issues, data issues and modeling/quantification issues.

   b. The 2006 Basel Report showed continued challenges in moving forward in Operational Risk management, including:

      (i) The nature and extent of active involvement required of a bank's board and senior management in the oversight of the Operational Risk management framework.

      (ii) How to best maintain the independence of the Operational Risk management function.

      (iii) How to carry out most effectively an independent assessment by internal and/or external parties of the bank's Operational Risk management and measurement framework, given the paucity of operational loss data and the early stage of development of Advanced Measurement models in respect of Basel II capital.

(iv) The need for banks to substantiate how they quantify the impact of "business environment and internal control factors" (e.g., rate of growth, new product introductions, internal audit results, employee turnover, system downtime) on their capital calculation.

4. Reconciliation of Regulatory Overlap for the Management and Supervision of Operational Risk in U.S. Financial Institutions (Financial Services Roundtable, May 20, 2005) concludes that a close review of applicable banking and securities laws -- including the Federal Deposit Insurance Corporation Improvements Act (FDICIA), the Gramm-Leach-Bliley Act, 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 internal control systems and processes, and their impact on Operational Risk.

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

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

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

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

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

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

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 vigilant and proactive in assisting in the identification, monitoring and mitigation of these risks.

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

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

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

   b. A formal policy to 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.

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

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

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

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

4. Among the key areas focused on to build a "culture of compliance" are:

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

b. Employee training and self-assessments.

c. Procedures for prompt redress of reporting problems.

d. Cooperation with regulators.

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

f. Limitations on outsourcing the compliance function.

5. 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 reviews are done in a cursory manner, or their results are either ignored or not acted on.

d. USA PATRIOT Act/Bank Secrecy Act ("BSA")/Office of Foreign Assets Control ("OFAC") requirements are neglected.

e. Reputational Risk issues are not given serious attention.

6. Broad factors that have emerged from recent developments in respect of the regulatory/administrative evaluation of Operational Risk management include:

a. The importance of "tone-at-the-top" from a Legal, Compliance and Operational Risk management perspective.

b. The expectation that financial institutions be attentive to all of the many different sources of risk management guidance and statements of risk management concerns (including regulatory orders, staff opinions, speeches and presentations, publicly-available correspondence, etc.).

c. The increasingly-perceived globalization of regulatory focus, communication, coordination and enforcement.

d. The importance of the manner in which a financial institution identifies and responds to "red flags" given the nature of its business, and the nature and scope of the institution's cooperation with regulatory/administrative inquiries.[11]

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[11] See, e.g., U.S. Chamber of Commerce Report on the Current Enforcement Process of the [SEC] (March 2006); SEC Release No. 2006-4 (January 4, 2006) (framework for determining whether, and if so to what extent, to impose civil penalties); SEC Litigation Release No. 19517 (January 3, 2006) (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").

C. Key Current Legal and Compliance Issues[12]

1. Responsibility for (a) building a "culture of compliance," (b) assuring compliance with "best" operational, ethical and business practices, and (c) implementing effective codes of conduct.[13]

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

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[12] 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 financial holding companies ("FHCs") and bank holding companies ("BHCs"). 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 2007 (e.g., SEC "broker push-out rules"); or (iii) front/back office business line-related risk management processes and procedures, lending/investment issues, capital-related issues, derivatives/foreign exchange transactional issues, or similar areas that would not primarily represent a legal/compliance responsibility.

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 (SIFMA, October 2005); "The Costs of Compliance in the U.S. Securities Industry", SIFMA Research Reports (August 31, 2005).

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

a. Participation in elevated risk CSFTs, other 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:[14]

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

b. Identifying conflict of interest-related issues involves (i) an appropriate "tone-at-the-top"; (ii) a firm-wide, "top-to-

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[14] See also Part II.C.14.b below.

bottom" review of business operations; and (iii) a comprehensive strategy for conducting a conflicts review ("follow-the-money").

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

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.[15]

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 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

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[15] 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.

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 reasonably designed to manage the credit exposure rising from its derivative transactions with affiliates in a safe and sound manner.

(A) These policies must, at a minimum, provide for (1) 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 (2) ensuring that the bank's derivative transactions with affiliates comply with the Market Terms Requirement.

(B) OCC Letter No. 1018 (February 10, 2005), CCH Fed. Banking L. Rep. ¶ 81-547, approved a national bank's proposal to enter into equity derivatives transactions with subsidiaries and affiliates in order to manage risk arising out of such affiliates/subsidiaries' derivatives transactions with customers. The bank -- which represented to the OCC that the proposed transactions would accomplish a cost effective centralization of risk management of equity derivatives transactions -- was previously authorized to enter into similar derivatives transactions directly with its own customers. The OCC conditioned its approval on the bank's having appropriate risk management and monitoring procedures in place and on the bank's representations to implement safety and soundness practices designed to ensure compliance with Section 23B (including the Market Terms Requirement), and commitment that the affiliates would post collateral to cover the mark-to-market amount owed to the bank under such transactions.

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

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

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

(vii) Bank support to funds advised by banking organizations or their affiliates (including through credit extension, cash infusion, asset purchases and acquisition of fund shares).[17]

5. Focus on compliance with Section 106 of the Bank Holding Company Act ("BHCA") Amendments of 1970 (the "Anti-tying Statute").[18]

a. 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

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16 See, e.g., Board Letter to Bank of America, dated June 7, 2005.

17 See Bank Activities Guide at Part VIII.B.1.c.viii.

18 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 (defined below)) 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).

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 also applies to (i) "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 (ii) "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.

b. As the Board indicated in its proposed interpretation of the Anti-tying Statute, 68 Fed. Reg. 52024 (August 29, 2003) (solicitation of public comments) (the "Proposed Anti-tying Interpretation"), 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.

c. In 1997, in its amendment to Regulation Y, the Board eliminated the former regulatory extension of the Anti-tying Statute to 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).

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

(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.

e. 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.

This standard does not prohibit:

(i) A customer from deciding on its own to award some of its business to a bank or an affiliate as a reward for previously providing credit or other services.

(ii) 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.

(iii) 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").

(iv) 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.

f. A bank may impose a condition or requirement that it receive additional business from a customer if the bank provides the customer the freedom to choose whether to satisfy the condition or requirement through the purchase of one or more traditional bank products or "non-traditional" products (a "mixed-product arrangement").

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

(ii) Application of the mixed-product arrangement analysis indicates that "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.

g. 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/pricing, and marketing) reflect the Statute's prohibitions and are appropriate for the bank taking into account the bank's size, and the nature, scope and complexity of the bank's activities (including activities conducted in conjunction with affiliates).

h. 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) 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.

i. NASD Notice to Members No. 02-64 (September 2002) expressed concern about the practice of tying commercial credit to investment banking and noted that tying issues usually arise in three contexts: (i) bridge loans in which the loan is intended to be repaid out of the proceeds of a bond offering; (ii) backup credit facilities that support a company's issuance of commercial paper; and (iii) 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."[19]

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;[20] 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 in 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 merchants, money transmitters, check cashing operations, insurance companies, trust companies).

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[19] See also NASD Rules 113, 2120, 2310, 2710(c).

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

(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.[21]

(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 equity-related 4(c)(6) Investments.

(vi) The Board's Regulation K, 12 C.F.R. Part 211: investments in certain foreign companies engaged exclusively (or predominantly) in business outside the U.S.

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

(viii) Bank authority under National Bank Act in appropriate circumstances to take as consideration for a loan, or for other banking services (A) a share in profits, income, production payments, earnings or property

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[21] See, e.g., Board Letter, dated September 29, 2006 (no "fiduciary ownership"/asset management exemption under Board Regulation O, 12 C.F.R. Part 215; combined proprietary/fiduciary ownership of, or right to vote or dispose of, 10% or more of a class of voting securities could require Regulation O compliance in respect of loans or other transactions between bank in which investment is held and entire corporate group of investor/fiduciary); Board Letter re Franklin Resources, dated November 29, 2004, and Board Letter to Capital Group Companies, dated August 13, 2002 (addressing limited fiduciary ownership exception in respect of banks/BHCs in the BHCA).

appreciation from a borrower, whether in addition to, or in lieu of, interest or other compensation for services, and/or (B) warrants, options or conversion or other rights to acquire equity.[22]

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

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

7. Identification and monitoring of key risk indicators with respect to derivatives transactions,[23] 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. Depending on the nature of the asset underlying the derivative, complying with other regulatory/licensing requirements (e.g., receipt of Federal Energy Regulatory Commission authority to engage in market-based transactions in electricity, membership in "independent system operators" (ISOs) and "regional transmission organizations" (RTOs) to execute electricity derivative transactions).

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[22] See 12 U.S.C. § 24(7); 12 C.F.R. § 7.1006.

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

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

8. Recognition of responsibilities with respect to participation in trading activities, including standards of fair practice, and policies, procedures and controls to guard against manipulative behavior in any applicable market.[24]

9. 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.[25]

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24 See, e.g., Remarks of Department of the Treasury Assistant Secretary for Federal Finance Clouse, September 27, 2006 (perceived increase in aggressive trading practices in cash, repurchase agreement ("repo") and futures markets for U.S. Treasury securities that have raised questions as to whether firms have sought to gain control over Treasury issues and used that power to their advantage, distorting prices in cash, repo and futures markets); remarks of FRBNY Executive Vice President Kos, December 6, 2001, Remarks of FRBNY Executive Vice President Fisher, January 16, 1997, October 8, 1996 (standards of market manipulation and "abusive squeezes" in respect of repo transactions in Treasury securities). See also, e.g., Fenchurch Capital Management, SEC Litigation Release No. 14977 (July 10, 1996), Commodity Futures Trading Commission Release No. 3922-96 (July 10, 1996) (charges related to certain Treasury market repo and futures trading).

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

See also, e.g., Joint Statement of Industry Associations Regarding the Communication and Use of Material Non-Public Information (December 13, 2006); Loan Syndications and Trading Association Statement of Principles for the Communication and Use of Confidential Information by Loan Market Participants (October 2006) (outlining principles and recommendations that (i) loan market participants should implement and maintain controls for handling syndicate information in order to avoid entering into securities transactions on the basis of

(fn. cont.)

10. Review/evaluation of "outsourcing" and "offshoring" contracts and arrangements. Appropriate due diligence of service providers, particularly of cross-border engagements, is increasingly important in respect of such matters as (a) contractual expectations; (b) security and confidentiality of bank and customer information; (c) vendor performance standards, legal compliance systems, risk management programs and financial condition; (d) business continuity and disaster recovery; and (e) evaluation of "country risk" in terms of stability, applicability of foreign law and contract enforcement.[26]

(fn. cont.)

material non-public information; (ii) a firm's information controls should be tailored to the nature and scope of its business activities and operations; and (iii) loan market participants should consider including certain key elements in their information controls, such as information walls, trading restrictions, restricted lists and watch lists); Joint Market Practices Forum Statement of Principles and Recommendations Regarding the Handling of Material Non-public Information by Credit Market Participants (October 2003) and European Supplement (May 2005). See generally, e.g., Morgan Stanley, SEC Admin. Proc. No. 3-12432 (June 27, 2006) (fine for failure to maintain and enforce written policies and procedures to prevent the misuse of material non-public information).

[26] See Bank Activities Guide at Part I.B.6.f and Part IX.B.2.

See also, e.g., FDIC FIL-52-2006 (June 21, 2006) (Foreign-based Service Providers: Guidance on Managing Risks in These Outsourcing Relationships) (principal risks associated with such relationships, and recommended risk management steps (including due diligence, contractual protections, monitoring and oversight and access to information)); 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; rewrite expected in response to public comments)); Basel Committee/International Organization of Securities Commissions ("IOSCO")/International Association of Insurance Supervisors Report: Outsourcing in Financial Services (February 2005).

11. Focus on compliance with banking and securities law requirements in connection with international securities transactions/linkages, in terms of licensing and supervision.[27]

12. Relationships between banks/broker-dealers and hedge funds, including in respect of space leasing, service arrangements, brokerage compensation, disclosures, and treatment of hedge fund clients in comparison with other clients.[28]

13. Focus on compliance with USA PATRIOT Act/BSA/OFAC, including in respect of (a) anti-money laundering ("AML") policies, (b) suspicious activities report ("SAR") tracking/monitoring/filing, (c) implementation of adequate customer identification/know-your-customer procedures, (d) trade finance, (e) foreign correspondent

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

See also, e.g., Credit Agricole Asset Management Alternative Investments (avail. August 7, 2006) (U.S. limited purpose investment adviser subsidiary of non-U.S. bank prohibited from registering with the SEC as an investment adviser subsidiary under the Investment Advisers Act of 1940 where such subsidiary (i) only provides certain limited advisory services (and no other services; in particular, no services which involve the exercise of investment discretion); and (ii) only provides such services to three of its affiliates which in turn provide advice only to non-U.S. funds-of-funds and related vehicles in which only non-U.S. persons invest).

[28] See Bank Activities Guide at Part II.D.4.

See also, e.g., Precautions that Pay Off: Risk Management and Valuation Practices in the Global Hedge Fund Industry (Deloitte Research, 2007); The Regulatory Environment for Hedge Funds: A Survey and Comparison (IOSCO, November 2006); Hedge Funds: A Discussion of Risk and Regulatory Engagement (U.K. Financial Services Authority, March 2006); Sound Practices for Hedge Fund Managers (Managed Funds Association, 2005) (recommendations respecting (i) management and internal controls; (ii) risk measurement and monitoring; (iii) responsibilities to investors; (iv) valuation policies; (v) regulatory controls; (vi) transactional practices (including in respect of documentation, best execution responsibilities and "soft dollar" arrangements); and (vii) disaster recovery and business continuity).

account review, and (f) diligence in respect of U.S. and non-U.S. shell companies and tax havens.[29]

Recent enforcement orders and other guidance relating to SAR/AML programs emphasize the importance of a financial institution (i) fostering a culture of compliance; (ii) ensuring that the SAR/AML compliance function is adequately led, staffed and supported; (iii) maintaining detailed and up to date written policies that specifically address the institution's risks; (iv) assuring that policies are followed, that customer identification programs are robust, and that documentation (including of any exceptions to policy implementation) is accurate and complete; (v) understanding the normal/expected transactions of each customer and periodically reviewing a customer's account activity to update the parameters of "normal" activity if necessary; (vi) establishing a methodology to assign risk levels to different types of customers and products; (vii) providing enhanced due diligence for customers, products and geographic areas that pose higher risks; (viii) establishing internal procedures for reporting information about potentially suspicious transactions; (ix) engaging senior management in the process of identifying and reviewing significant SAR issues; (x) conducting rigorous independent testing; and (xi) responding quickly and fully to regulatory criticism and to issues identified by independent testing.

14. Sensitivity to special concerns relating to broker-dealer/investment adviser and related compliance responsibilities.[30]

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29 See Bank Activities Guide at Part VIII.A.

See also, e.g., SEC/Financial Crimes Enforcement Network ("FinCEN") Information Sharing Agreement, dated December 21, 2006; The Role of Domestic Shell Companies in Financial Crime and Money Laundering: Limited Liability Companies (FinCEN, November 2006); FinCEN Guidance FIN-2006-G014 (November 9, 2006): Potential Money Laundering Risks Relating to Shell Companies; The Misuse of Corporate Vehicles, Including Trust and Company Service Providers (Financial Action Task Force, October 13, 2006); Bush & Carroll, "Suspicious Activity Reporting: Recent Developments and Guidance on Key Issues", Review of Banking & Financial Services (November 2005).

a. Compliance with the SEC's "Dealer Push-out Rules", effective October 1, 2003, which limit the activities of U.S. banks, as principal, involving certain securities.[31] Open issues in this context relate to (i) how repurchase transactions on securities which are not exempt securities or "identified banking products" should be treated for purposes of the limited continuing exemption for banks from "dealer registration"; (ii) whether cash/physically settled forward transactions should be characterized as "identified banking

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(fn. cont.)

[30] See Bank Activities Guide at Part IX.E.

See also, e.g., SIFMA Survey Report: The Costs of Compliance in the U.S. Securities Industry (February 2006); SIFMA Research Reports (August 31, 2005) (key aspects of a broker-dealer compliance function include (i) providing ongoing regulatory and compliance advice to business and control units; (ii) assisting management in the development of policies, procedures and guidelines to facilitate compliance with applicable laws and regulations; (iii) educating and training business personnel and keeping employees apprised of policies, procedures and regulatory events; (iv) monitoring business activities, transactions and communications to identify potential issues, patterns of improper behavior, material or systemic weaknesses, and potential product-related problems; (v) conducting business unit compliance reviews; (vi) assessing compliance programs and centralizing compliance functions; (vii) supervising licensing, registration and employment-related functions (including by conducting due diligence on new employees, and advising on disciplinary issues); (viii) conducting internal inquiries and investigations into potential violations of supervisory and regulatory restrictions; (ix) facilitating regulatory examinations, reporting and investigations; and (x) fostering regulatory relationships and a culture of compliance). See generally North American Securities Administrators Association News Release, September 18, 2006 (recommended best practices for broker-dealers and investment advisers).

[31] See Bank Activities Guide at Part II.C and Part II.D.3.b.

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

products"; (iii) the scope of the applicable bank dealer exemption in the context of hedges of equity/credit derivative transactions; and (iv) the treatment of loan participations which do not fall literally within the scope of "identified banking products".

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

(i) Maintenance and implementation of an appropriate "culture of compliance", including (A) compliance oversight; (B) codes of conduct; (C) identification and control of compliance risks; (D) implementation of well-resourced compliance and supervisory systems appropriately tailored to operating businesses and risks; (E) communication, education and training; (F) internal processes to monitor and audit the compliance system; (G) effective reporting and resolution of significant compliance issues; and (H) response to violations and non-compliant actions.[33]

(ii) Conflicts of interest, including (A) disclosure-related issues (e.g., payments by mutual funds to broker-dealers and the use of soft dollars); (B) misuse of customer trading information or other non-public information (e.g., front-running); (C) allocation of limited products, services or opportunities to favored clients (e.g., hedge fund clients) or provision of special

[32] See, e.g., Remarks of SEC Director of Enforcement Thomsen, November 13, 2006; Remarks of SEC Office of Compliance Inspections and Examinations Director Richards, October 19, 2006; Remarks of SEC Commissioner Nazareth, September 13, 2006; Remarks of SEC Office of Compliance Inspections and Examinations Associate Director Gadziala, May 16, 2006, October 19, 2005; Remarks of Associate Director of SEC Office of Compliance Inspections and Examinations Walsh, April 18, 2006.

[33] See, e.g., NASD Press Release, December 18, 2006 (USAllianz Securities fined for failure "to establish and maintain a reasonable supervisory system").

incentives or payments for use of products or services; (D) use of products or services of affiliates or favored clients (e.g., hedge fund clients); (E) playing multiple roles in a transaction or with respect to an issuer or client; (F) biased research, advice or trading (e.g., "spinning", "churning", trading ahead of customers/ research reports/anticipated underwritings); (G) accounting, booking or reporting to achieve other interests; and (H) gifts and entertainment to and from clients.[34]

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

(iv) Trading and pricing practices; e.g., insider trading issues, front-running, misuse of customer trading data or other non-public information, satisfaction of best execution responsibilities (including in the context of mark-ups (e.g., on corporate and municipal bonds), and in the context of "bundled" commissions and the pricing of principal and agency trades) and policies and procedures to avoid market abuses.

(v) Introduction of hedge fund clients to public customers.

(vi) Creation and marketing structured finance products.

[34] See also Part II.C.3 above.

(vii) Internal controls (including risk management and separation of banking from research), reporting, books and records, and e-mail retention.[35]

(viii) Procedures to prevent misappropriation of customer assets.

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

(x) Information security.

c. With respect to investment advisers/investment companies recent areas of compliance interest include:[36]

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

(ii) Conflict of interest disclosure/resolution (including in respect of trade allocations among clients, side-by-side management of hedge funds, etc.).[37]

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

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35 See, e.g., NASD Press Release, September 5, 2006 (Morgan Stanley fined for reporting and rule violations).

36 See, e.g., Remarks of SEC Director Richards, December 5, February 27, 2006; Remarks of SEC Office of Compliance Inspections and Examinations Associate Director Gohlke, October 19, 2006; Remarks of SEC Associate Director Walsh, April 18, 2006.

37 See also Part II.C.3 above.

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

(v) Use of brokers and satisfaction of best execution responsibilities.

(vi) AML compliance.

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

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

(ix) Advertising and performance claims.

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

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

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

(xiii) Information security.

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

(xv) Custody of client assets (including in respect of securities lending).

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