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Overview of Key U.S. Compliance Issues for International Banks

U.S. Regulatory/Compliance Orientation for Head Office and Recently Arrived Officers of International Banks

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What is Compliance and Why is it Important?

Compliance Overview

- Compliance with U.S. laws, regulations and policies, and increasingly, codes of conduct and similar standards that apply to a foreign bank's business activities and operations
- Increased focus by U.S. banking regulators, especially as part of overall risk management program
 - See SR 08-8/CA 08-11, *Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles* (supervisory guidance to clarify FRB views on compliance risk, focusing primarily on firm-wide compliance risk management for large banking organizations with complex compliance profiles, including FBOs), October 16, 2008
 - See Testimony of Roger T. Cole, Director, Division of Banking Supervision and Regulation, *Risk Management in the Banking Industry*, March 18, 2009
 - See Speech by Susan Schmidt Bies, FRB Governor, *A Supervisor's Perspective on Enterprise Risk Management*, June 12, 2006
 - See Speech by Mark W. Olsen, FRB Governor, *Compliance Risk Management in a Diversified Environment*, May 16, 2006
 - See Paper by Basel Committee on Banking Supervision, *Compliance and the compliance function in banks*, April 2005; see also follow-up survey: *Implementation of the Compliance Principles: A Survey*, August 2008
- Noncompliance presents legal, economic, and reputational risks

Compliance Overview (cont'd)

- Risk of significant enforcement actions/penalties
 - Criminal charges and \$500 million in fines and penalties assessed against by the DOJ for transactions in jurisdictions subject to OFAC sanctions, and for failure of the New York branch to maintain adequate anti-money laundering procedures and processes (2010)
 - Criminal charges and \$536 million in fines and penalties assessed against by the DOJ and the state of New York, for transactions in jurisdictions subject to OFAC sanctions (2009)
 - Criminal charges and \$780 million in fines and penalties assessed against a foreign bank, resulting from U.S. tax and securities law violations involving cross-border private banking services (2009)
 - Criminal charges and \$567 million in cumulative fines and penalties assessed by the DOJ and the state of New York against a foreign bank for transactions in jurisdictions subject to OFAC sanctions (2009/2010)
 - Numerous actions against foreign banks for deficient anti-money laundering compliance policies and practices, including criminal sanctions and civil money penalties, and for deficient global compliance and risk management systems

Compliance Overview (cont'd)

- Stakes are getting higher, and maintaining compliance is becoming harder
 - Increased cross-border issues and activities
 - Larger, more complex organizations
 - More and more laws and standards
- Important to Basel II regime
 - Compliance risk closely tied to operational risk/fraud

Compliance Tips

Compliance Program

- Compliance policies, procedures, and organization will depend on the size, risk profile, and scope/structure of the U.S. offices and activities
 - FBOs with over \$50 billion in total U.S. third-party assets, and having multiple legal entities, should implement a U.S. operations-wide risk management program, with dedicated corporate compliance functions
 - Smaller FBOs and large FBOs with limited range of activities/entities can rely on less robust measures
 - FBOs with U.S. operations should have a local compliance program that is specifically designed to ensure compliance with U.S. laws
 - FBOs have flexibility to work within head office's existing compliance oversight structure
- Regulators look for board/senior management oversight and tone-setting; proper identification and measurement of key risks; effective communication and reporting of risks within the organization; policies and procedures; internal controls; monitoring and reporting; testing; and training

Compliance Program (cont'd)

- Consider and clarify relationships to business lines, head office counterparts, legal, internal audit
 - *E.g.*, compliance staff independence from business lines a key issue
 - Centralized compliance function; or
 - If compliance is integrated with business lines, FRB guidance suggests that the following steps be taken to ensure independence:
 - Dual reporting line to corporate compliance function
 - Corporate compliance function should play key role in personnel decisions and how compliance matters are handled
 - Compensation for compliance staff not based on business line performance
 - Enhanced oversight to identify and address conflict of interest issues

Compliance Program (cont'd)

- Communication with/involvement of head office is important
 - Increased focus on firm-wide compliance risk management
 - Extraterritorial nature of many aspects of U.S. law/regulation (e.g., BHCA nonbanking prohibitions; AML/OFAC; U.S. securities and tax laws)
- Pay attention to regulatory and litigation trends and priorities

Key Compliance Issues

BHCA Compliance Issues

General

- A BHC is a company that “controls” a bank
 - Control over a bank is defined as owning or controlling 25 percent or more of any class of the bank’s voting securities, having the power to select a majority of its board of directors or otherwise exercise a controlling influence over its management
 - Concept of control is complex and relevant in many contexts under BHCA
 - Requires aggregation of holdings across the organization
- Foreign banks that have U.S. branches or agencies but do not have U.S. bank subsidiaries are not BHCs, but are treated like BHCs for most purposes

BHCA Compliance Issues

Section 3 of the BHCA

- Requires prior FRB approval for foreign bank acquisitions of 5% or more of voting securities of a U.S. bank or BHC
- Also applies to acquisitions of interests in foreign banks that have U.S. bank subsidiaries
- Although prior FRB approval is required for the acquisition of a U.S. savings association under Section 4 of the BHCA (because it is not a “bank” for purposes of the BHCA), the regulatory application is reviewed and processed much like a bank application under Section 3 of the BHCA (also requires approval from the Office of Thrift Supervision – which will change under new the new financial reform legislation – under a separate statutory regime)

BHCA Compliance Issues

Section 4 of the BHCA

- Section 4 of the BHCA governs the nonbanking activities and investments of BHCs and foreign banks with U.S. branches and agencies
- All (i.e., worldwide) nonbanking activities and investments are prohibited unless an exemption exists
- Also applies to companies (but not individuals) controlling the foreign bank
- Requires aggregation across the organization

BHCA Compliance Issues

Section 4 of the BHCA (cont'd)

- Key Exemptions Under Section 4 of the BHCA
 - General Exemptions (some require applications/notice; many are self-executing)
 - Closely Related to Banking – BHCA Section 4(c)(8); 12 CFR 225.28 (e.g., lending, securities brokerage/private placement, trust and advisory activities, leasing, derivatives)
 - Servicing Activities – Section 4(c)(1)(C); 12 CFR 225.22(b) (acting as agent for U.S. branches and other affiliates in providing services to third parties; and internal services for affiliates)
 - Noncontrolling Investments – Section 4(c)(6); 12 CFR 225.22(d)(5) (e.g., less than 5% “passive” investments)
 - Financial in Nature and Complementary Thereto – (financial holding company (FHC) status required) BHCA Section 4(k); 12 CFR 225.81 et seq (e.g., energy trading)
 - Fiduciary holdings – BHCA Section 4(c)(4); 12 CFR 225.22(d)(3)
 - Shares/assets acquired pursuant to loan workouts or foreclosures – Section 4(c)(2); 12 CFR 225.22(d)(1)

BHCA Compliance Issues

Section 4 of the BHCA (cont'd)

- Special exemptions for foreign banks that are Qualified Foreign Banking Organizations (QFBOs)-- BHCA Sections 2(h)(2) and 4(c)(9); Regulation K (12 CFR 211.23)
 - Blanket exemption for all activities outside the United States, including investments in non-U.S. companies with no U.S. “activities;”
 - U.S. activities that are “incidental” to international banking activities;
 - Investments in non-U.S. companies that conduct activities in the U.S., subject to certain complex conditions and limitations
 - “U.S. activities” in this context generally means having a direct U.S. office or subsidiary
- Impact of Volcker Rule

BHCA Compliance Issues

Section 4 of the BHCA (cont'd)

- QFBO status
 - foreign banking organization with (i) more than half of its worldwide business in banking (disregarding its United States banking business) as opposed to nonbanking, and (ii) more than half of its banking business outside the United States

BHCA Compliance Issues

Practical Compliance Considerations

- Requirement to aggregate/monitor holdings across the organization makes compliance difficult
 - *E.g.*, venture capital investment in non-U.S. company which decides to establish a U.S. subsidiary
 - *E.g.*, independent but 25% owned subsidiary of a foreign bank seeks to establish operations in the U.S. without realizing that FRB notice/approval is required
- Should implement organization-wide reporting/screening procedures to review proposed investments that “touch” the U.S.

Cross-border Private Banking Services for U.S. Residents

- U.S. tax law risks of undeclared U.S. customers
- U.S. securities law risks of providing securities transactional services or investment advice
 - Use of “U.S. jurisdictional means” (*e.g.*, U.S. mail, telephone, facsimile machine, e-mail) triggers registration requirement in absence of exemption
- Recent developments
 - UBS case and aftermath
 - FATCA
 - SEC enforcement changes

Affiliate Transactions

- The FRB’s Regulation W, which implements Sections 23A and 23B of the Federal Reserve Act, imposes restrictions on extensions of credit and other “covered transactions” between U.S. banks and their affiliates, including U.S. banks that are owned by foreign banks
- Regulation W also applies to “covered transactions” between a U.S. branch or agency of a foreign bank and affiliates of the branch or agency engaged directly in FHC activities the United States, including the following activities:
 - Securities underwriting and dealing;
 - Non-credit-related insurance underwriting;
 - Merchant banking; and
 - Insurance company investments.

Affiliate Transactions (cont'd)

- Regulation W also applies to transactions between a U.S. branch or agency of a foreign bank and any portfolio company controlled by the foreign bank under merchant banking or insurance company investment authorities
- Regulation W does not apply to transactions between a U.S. branch or agency of a foreign bank and other affiliates or to transactions between the foreign bank's non-U.S. offices and its U.S. affiliates
- New financial reform legislation tightens Sections 23A and 23B
 - Regulation W implementing regulations likely to follow

Anti-Tying

- The anti-tying prohibitions of section 106 of the Bank Holding Company Act Amendments of 1970 apply to U.S. branches and agencies of foreign banks
- Section 106 generally prohibits conditioning the availability or price of one product or service (the “tying” product) on a requirement that the customer obtain another product or service (the “tied” product) from the U.S. branch or agency or an affiliate of the U.S. branch or agency
- Exceptions are available for:
 - Traditional bank products, such as a loan, discount, deposit or trust service
 - Foreign transactions, i.e., with non-U.S. persons
 - Discounts for combined products

Regulatory Reporting Requirements

- FBOs that have a U.S. banking presence (i.e., not just a representative office) are required to file certain regulatory reports, including the following:
 - Annual Report of Foreign Banking Organizations (FR Y-7) – financial statements, organization charts, shareholder information, QFBO calculation (annual)
 - Capital and Asset Report for Foreign Banking Organizations (FR Y-7Q) – reports capital and asset components of regulatory capital ratios (quarterly for FHCs; annual for others)
 - Report of Changes in Organizational Structure (FR Y-10) – reports investments in U.S. companies and other organizational structure changes (event driven; 30 days)
 - Financial Statements of U.S. Nonbank Subsidiaries Held by Foreign Banking Organizations (FR Y-7N/FR Y-7NS) – reports financial information for U.S. nonbank subsidiaries (quarterly or annually, with frequency and detail depending on asset size)
 - FFIEC 002 – “call report” providing detailed financial information for U.S. branches and agencies (quarterly)

Other Current Topics in Regulatory Compliance

- Bank Secrecy Act/Anti-Money Laundering (covered elsewhere)
- Office of Foreign Assets Control (OFAC) Sanctions (covered elsewhere)
- Dodd-Frank Wall Street Reform and Consumer Protection Act
 - Bureau of Consumer Financial Protection, derivatives push-out requirements, Volker Rule prohibitions, Collins Amendment capital requirements
- Foreign Corrupt Practices Act of 1977 (FCPA)
 - FCPA addresses corporate slush funds, illegal campaign contributions and international bribery (applies to foreign companies with American Depositary Receipts or other securities listed on U.S. exchanges)

Other Current Topics in Regulatory Compliance (cont'd)

- New Home Mortgage and Credit Card Rules
 - Regulation Z amendments (74 Fed. Reg. 43321 and 74 Fed. Reg. 43427 (Aug. 26, 2009))
 - Credit CARD Act of 2009, Pub. Law 111-24, and implementing regulations (74 Fed. Reg. 36077 (July 22, 2009), 74 Fed. Reg. 7658 (Feb. 22, 2010), and 75 Fed. Reg. 37525 (June 29, 2010))
 - SAFE Act and implementing regulations (74 Fed. Reg. 27386 (June 9, 2009))
- Privacy/Data Security
 - Treatment of nonpublic personal information about individuals who obtain financial products or services primarily for personal, family, or household purposes
- Internet Gambling
 - See 73 Fed. Reg. 69382 (Nov. 18, 2008) (final rule), and 74 Fed. Reg. 62687 (Dec. 1, 2009) (extending compliance date to June 1, 2010)
 - Interagency Examination Procedures issued May 20, 2010
- Outsourcing/Third Party Arrangements