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

2013 IIB/CSBS U.S. Regulatory/Compliance Orientation Program

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November 4, 2013

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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
- Key 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 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
 - See Paper by Financial Stability Board, *Thematic Review on Risk Governance*, February 2013
 - See Speech by Thomas J. Curry, OCC, *Bank Supervision*, March 14, 2013
- Noncompliance also presents legal, economic, and reputational risks

Compliance Overview (cont'd)

- Risk of significant enforcement actions/penalties
 - \$453 million in fines and penalties assessed by the FERC for manipulation of energy trading markets (2013) (Barclays)
 - Criminal charges and \$1.5 billion in fines and penalties assessed by the DOJ, CFTC, Finma, and FSA for manipulation of LIBOR rates (2012) (UBS)
 - Criminal charges and \$1.9 billion in fines and penalties assessed by the DOJ, OCC, OFAC, New York County DA, Federal Reserve, and FinCEN for an ineffective compliance program that failed to identify or prevent money laundering (2012) (HSBC)
 - \$667 million in fines and penalties assessed against a foreign bank by the New York Department of Financial Services, New York County DA, Treasury, DOJ, and Federal Reserve for stripping origination data from transactions that originated with Iranian clients (2012) (Standard Chartered)
 - Criminal charges and \$619 million in fines and penalties assessed by the Treasury, DOJ, and the New York County DA for stripping origination data from transactions in violation of OFAC sanctions (2012) (ING)
 - Numerous actions, including criminal sanctions and civil money penalties, against foreign banks for deficient anti-money laundering compliance policies and practices and for deficient global compliance and risk management systems

Compliance Overview (cont'd)

- Stakes are getting higher, and maintaining compliance keeps getting harder
 - Larger, more complex organizations/multiple lines of business
 - More cross-border issues and activities/multiple jurisdictions
 - More and more laws and standards (e.g., Dodd-Frank)
- Important to Basel II/III regime
 - Compliance risk closely tied to operational risk/fraud

What are some of the key considerations for establishing an effective compliance program?

Compliance Program

- Compliance policies, procedures and organization should be based on the size, risk profile, and scope/structure of 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 a dedicated corporate compliance function that reports directly to the governing body or an appropriate committee of the governing body
 - Smaller FBOs and large FBOs with relatively limited range of activities/entities can rely on less formal 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
- Pay attention to regulatory and litigation trends and priorities
 - *E.g.*, December 2012 HSBC AML/sanctions settlement

Compliance Program (cont'd)

- Regulators look for board/senior management oversight and tone-setting; proper identification and measurement of key risks; effective vertical and horizontal communication and monitoring and reporting of risks within the organization; appropriate policies and procedures
 - But also need internal controls; testing; and training
- Communication with/involvement of head office is important
 - Increased focus on enterprise-wide compliance risk management
 - Extraterritorial nature of many aspects of U.S. law/regulation (*e.g.*, BHCA nonbanking prohibitions; AML/OFAC; Dodd-Frank, especially derivatives provisions and the Volcker Rule; U.S. securities and tax laws)

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 objective
 - Centralized compliance function; or
 - If compliance is integrated with business lines, regulators will expect the following steps to ensure independence:
 - Dual reporting line for embedded compliance personnel to corporate compliance function
 - Personnel decisions and handling of compliance matters should not be determined by business unit
 - Compensation and evaluations of compliance staff should not be tied to business line performance
 - Embedded compliance personnel should focus purely on compliance

Compliance Program (cont'd)

- Regulators increasingly expect larger banks to separate their compliance and legal functions
- Proposed Dodd-Frank Section 165 enhanced prudential standards:
 - Risk committees for U.S. risk management for public FBOs with at least \$10B in global assets and all FBOs with \$50B in global assets
 - U.S. chief risk officer for FBOs with at least \$50B in US assets reporting to risk committee and global risk officer
- Status of compliance function within the organization also important
 - Senior officer as head of compliance
 - Direct report to audit committee
 - Ability to access information throughout the organization

What are some of the key
compliance issues for for
FBOs?

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. federal 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, and also requires approval from the OCC under separate statutory thrift regime

BHCA Compliance Issues

Section 4 of the BHCA

- Section 4 of the BHCA restricts 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 or governments) controlling the foreign bank
- Requires aggregation across the organization
- Volcker Rule, which applies to foreign banks with U.S. banking operations and their affiliates, raises similar issues

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” in this context generally means having a direct U.S. office or U.S. subsidiary
 - Also permits U.S. activities that are “incidental” to international banking activities;
 - Permits investments in non-U.S. companies that conduct activities in the U.S., subject to certain complex conditions and limitations
 - A QFBO is a 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

Some 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
- Need to 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 serving 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 – 2013 US-Swiss Joint Statement
 - FATCA
 - NRA interest reporting obligation
 - SEC developments
 - IRS Offshore Voluntary Disclosure Programs – 39,000+ enrolled
 - Tax treaties

Affiliate Transactions

- 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;
 - Insurance company investments; and
 - Certain transactions resulting in credit exposure to the affiliate.

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
- Dodd-Frank sections 608 and 609 tightened Sections 23A and 23B
 - Effective July 21, 2012
 - Regulation W implementing regulations to come

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
 - Recent changes require quarterly reporting beginning as of March 31, 2014 by any FBO with total consolidated assets greater than \$50B, not just FBOs that have elected to become FHCs
 - New line item will assist in calculation of new annual FRB Assessment Fee for FBOs that own U.S. banks and have \$50B+ in total assets
 - 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
 - Consumer Financial Protection Bureau, swap push-out requirements, derivatives regulation, Volcker Rule prohibitions, Collins Amendment capital requirements, private investment adviser registration, Section 165 enhanced prudential standards, foreign remittances
- 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)
 - DOJ/SEC guidance issued on November 14, 2012
 - SEC anti-bribery investigation of JPMorgan's Asian hiring practices announced in August 2013

Other Current Topics in Regulatory Compliance (cont'd)

- New Home Mortgage Rules
 - Regulations X and Z Amendments to mortgage servicer obligations (78 Fed. Reg. 10696 (effective Jan. 10, 2014)) and home ownership counseling and high-cost mortgages (78 Fed. Reg. 6856 (effective Jan. 10, 2014))
 - Regulation Z Amendments to loan origination compensation (78 Fed. Reg. 11280 (effective June 1, 2013 (section 1026.36(h)) and Jan. 10, 2014 (remainder))), ability-to-repay and qualified mortgages (78 Fed. Reg. 6408 (effective Jan. 10, 2014)), escrow requirements (78 Fed. Reg. 4726 (effective June 1, 2013)), and higher-price mortgage appraisals (78 Fed. Reg. 10368 (effective Jan. 18, 2014))
- Privacy/Data Security
 - Treatment of nonpublic personal information about individuals who obtain financial products or services primarily for personal, family, or household purposes; Protection of customer data against intrusion
 - Executive Order 13636, Improving Critical Infrastructure Cybersecurity (Feb. 2013)
- Outsourcing/Third Party Arrangements
 - October 31, 2012 FFIEC guidance on examination and supervision of technology service providers
 - Increased focus on payment processing relationships and sales of ancillary consumer products and services (*e.g.*, credit protection and credit monitoring) by third party vendors