



# **SIFMA Compliance & Legal Society 2010 Annual Seminar**

---

**BANK REGULATION PANEL**

Washington, D.C.  
Gaylord Convention Center  
May 6, 2010



## Bank Regulatory Issues – panel members

---

Moderator:

LaBrena J. Martin,  
Royal Bank of Canada

Panelists:

John Ayanian,  
Morgan, Lewis & Bockius

Karen Kirchen  
Citigroup

Evan Charkes,  
Morgan Stanley

John Ricketti,  
Federal Reserve Bank of NY

Richard Mumford,  
UBS Wealth Management Americas



# U.S. Bank Regulatory Regime -Overview

---

## ○ **Statutory Framework**

- Bank Holding Company Act
  - International Banking Act
  - Gramm Leach Bliley Act
- Permitted Activities
  - Reg Y
  - Reg K
- Certain Limitations on BHC Activities
  - Beneficial ownership of equity securities
  - Merchant banking
  - Affiliate transactions
  - Anti-tying



# U.S. Bank Regulatory Regime- Overview

---

## ○ **Banking Regulators**

- Board of Governors of the Federal Reserve
  - Supervision of bank holding companies (including Foreign Banking Organizations)
  - Examination authority/oversight of state chartered member banks
  - Prudential, “umbrella” oversight of functionally regulated nonbank subsidiaries of BHCs
- Office of the Comptroller of the Currency
  - Supervision of national banks
- Federal Deposit Insurance Corporation
  - Supervision of insured depository institutions
  - Supervision of state chartered non-member banks
  - Resolution authority for failed insured depositories



# U.S. Bank Regulatory Regime- Overview

---

- **Banking Regulators (cont'd)**
  - Office of Thrift Supervision
    - Supervision of savings & loans
  - State Banking Regulators
    - Supervision of state chartered member banks (shared with Federal Reserve)
    - Supervision of state chartered non-member banks (shared with FDIC)



# U.S. Bank Regulatory Regime- Overview

---

- **Approach to Supervision of BHC Activities**
  - Principles-based, to ensure safety and soundness of banking organizations
    - Objective is to protect viability of banking subsidiaries
  - Comprehensive, risk-focused review for adequacy of BHC governance structure
    - Risk management
    - Financial condition
    - Impact on bank operations
  - Key areas of assessment
    - Board oversight
    - Adequacy of internal controls (including over capital/liquidity)
    - Effective risk management programs
    - Contingency planning



# Becoming a BHC- Practical Updating the Compliance Program

---

- **Practical Considerations for a “new” BHC**
  - Formal, Board-approved appointments, mandates and programs
    - Chief Compliance Officer role
    - Global compliance plan
  - Formal articulation of compliance governance structure
    - Board oversight (roadmap)
    - Senior management accountability
    - Reporting line for Chief Compliance Officer
  - Dedicated monitoring and testing function
  - Staff training on becoming an FHC (Compliance and firm-wide)



# Becoming a BHC- Updating the Compliance Program

---

## ○ **Practical Considerations (cont'd)**

- Relationships with Banking Regulators
  - Designating firm representatives as primary points of contact with the Federal Reserve, OCC
  - Establishing regular, periodic communications
  - Providing updates on developments with functional regulators



# Becoming a Bank Holding Company – Updating the Compliance Program (Evan Charkes & John Ricketti)

---

## **Federal Reserve Supervision and Regulation Letter 08-8 (October 2008)**

Targeted to Organizations defined as Large and Complex

- Size test is \$50bn or more in consolidated assets
- Complex – activities cross business lines, legal entities, jurisdiction

Sets minimum standards for Firm-wide Compliance Program and oversight

- Program documented in the form of Policies and Procedures
- Oversight provided by separate Corporate Compliance Function



## SR LETTER 08-8

---

- Endorses 2005 Basel Banking Principles articulated by Basel Committee on Banking Supervision
- Describes Key Elements of Strong Risk Management
- Highlights importance of:
  - Independence of Compliance staff
  - Comprehensive Risk Assessment
  - Compliance Monitoring and Test Program
  - Oversight Responsibilities of Board and Sr. Management



## SR LETTER 08-8

---

### **Independence of Compliance Staff**

To minimize potential conflicts of interest, Compliance Staff must be independent of the business lines where they have compliance responsibilities

If dual reporting lines exist adhere to minimum standards:

- Key role of Corporate Compliance in actions affecting business line compliance staff and local compliance staff
- Compliance staff not compensated on basis of business line financial performance
- Enhanced Corporate Oversight applied on issues arising from conflicts of interest that affect business line compliance staff.



# SR LETTER 08-8

---

## Compliance Risk Assessment

- **Comprehensive**
  - Inventory of laws and regulations map to business line activities
- **Based on firm-wide standards**
  - Firm-wide method established to assess risk
  - Use of firm-wide criteria to assess risk
- **Consider**
  - Inherent risks of the activity
  - Effectiveness of controls to mitigate risks



## SR LETTER 08-8

---

### **Compliance Monitoring and Testing Program**

- Driven by Comprehensive Risk Assessment
- Scope and frequency of program based on the Compliance Risk Assessment



## SR LETTER 08-8

---

### **Compliance MIS**

- Key element of strong risk management program: reporting and escalation
  
- Elements of effective Compliance MIS
  - Clear
  - Accurate
  - Timely
  - Consistent with the firm's activities
  - Information sufficient to identify adverse trends, evaluate levels of risk



## Non Bank Subsidiaries – Consumer Compliance Supervision CA 09-08

---

- Policy Effective September 14, 2009
- Covers Large, Regional, Community and Foreign Bank Holding Companies
- Allows for Risk Based Consumer Compliance Exams to be conducted at Non Bank Subsidiaries
- Allows for Investigation of Consumer Complaints at Non Bank Subsidiaries



## Non Bank Subsidiaries – Consumer Compliance Supervision CA 09-08

---

- Exams will assess Consumer Compliance Risk Management Program
- Exams will test for compliance with applicable Consumer Protection Laws and Regulations
- Exam ratings will be provided (Strong, Satisfactory, Fair, Marginal, Unsatisfactory)
- Written Reports will be transmitted to senior Management of Nonbank subsidiary
- Exam Finding will be considered in the overall Bank Holding Company Rating



# Role of Audit and Bank Holding Company Supervision

---

- **Bank Holding Company Supervisor:**
  - Ability to look at the role of audit across all entities
  - Domestic institutions – generally one global audit function covers all entities including subsidiaries
  - Foreign institutions – may have a US audit group or could have separate audit functions at stand alone subsidiaries; evaluation of audit performed for all entities



# Role of Audit and Bank Holding Company Supervision

---

- **Leveraging off of internal audit:**
  - Evaluation of audit – critical component of BHC supervision
  - If audit is effective, supervisors can leverage off audit and reduce or change the scope of work performed
  - Key issues for leverage – scope and timeliness of audit reviews



## Review of Internal Audit

---

- Internal Audit Reviews – Critical Component of Supervision Processes
- Detailed Review of Internal Audit - required every three years under Consolidated Supervision; standards we benchmark against include IIA standards
- Analysis of Audit includes four key components:
  - The Role of the Audit Committee and Internal Audit Department Independence and Competency - active Audit Committee/Board oversight, an independent reporting line for audit, audit resources/qualifications/skills, detailed MIS on audit activities
  - Internal Audit's Methodology, Plan, and Risk Assessments
  - Quality of Audit Work - planning memo, scope, audit program, work papers, appropriate sample sizes, adequate documentation
  - Audit's Ancillary Processes – audit reports, audit tracking system



# New Areas of Emphasis by Internal Audit

---

- Evaluation of governance and strategic processes – should be focusing on tone at the top
- Analysis of cross business and functional risks
- Identification and escalation of thematic control issues
- Challenging the adequacy of controls – particularly in risk management and cross-institutional
- Informing management of key infrastructure weaknesses
- Understanding management's business strategy and risk tolerance – clear articulation
- Evaluation of fraud risk and its impact on specific areas
- New products and profitability – involvement of audit



# Internal Audit “Best Practices” and “Trends”

---

- **“Best Practices”:**
  - Quarterly Continuous Monitoring or Auditing
  - Training in Fraud Risk
  - Quality Assurance
  - Independent Review of Internal Audit
  - Computer Assisted Auditing (CAAT)



# Internal Audit “Best Practices” and “Trends”

---

- **Trends at Some Large Institutions**

- No audit cycle – “high risk” areas audited annually – requires robust risk assessment and effective quarterly continuous monitoring
- Global audit coverage with matrix reporting lines based on business considerations – e.g. separate group for investment management and private banking



# Retail Bank/Brokerage Issues (John Avanian)

---

## ○ Regulation R: Practical Overview from Retail Perspective

- In 2008/2009: implemented provisions of Gramm Leach Bliley Act of 1999
- Joint regulation of the SEC and the Federal Reserve
- Third-party networking arrangements and incentive compensation
  - “Incentive Compensation” is “intended to encourage a bank employee to refer customers to a broker or dealer, or give a bank employee an interest in the success of a securities transaction.”
  - Does not include a compensation paid by a bank under a bonus or similar plan that is:
    - Paid on a discretionary basis; and
    - Based on multiple factors or variables and
      - Are not related to securities transactions at the broker-dealer;
      - A referral by an employee is not factored into compensation under the plan; and
      - The employee’s compensation is not determined by reference to referrals made by others.



## Retail Bank/Brokerage Issues

---

### ○ **Regulation R**

- Unlicensed bank employees generally may receive discretionary bonuses based on the overall profitability or revenue of:
  - The Bank;
  - Any affiliate other than a broker-dealer; or
  - A broker-dealer, if:
    - One of several factors or variables used;
    - Including multiple, significant factors or variables not including brokerage revenue or profitability; and
    - Referral by that employee or any other not a factor.



## Retail Bank/Brokerage Issues

---

### ○ **Bank Deposit Sweep Programs**

- Use of negative consent to establish bank sweep programs
- NYSE Information Memo 05-11
- Exchange Act Release No. 34-55431 (March 9, 2007)
  - SEC proposed amendments to Rule 15c3-3 to add new section regarding treatment of free credit balances.
  - Proposed FINRA Rule 3260 (replacing NASD Rule 2510), would not address bulk transfers from money market mutual to bank sweep programs.
- Areas of recent regulatory focus in connection with bank sweeps



# Bank Regulatory Oversight of Institutional Securities Activities (Karen Kirchen)

---

- Key Concepts in a “Post-Crisis” Environment
  - Enhanced focus on risk takers
    - Fundamental governance initiatives
      - Risk-aligned compensation policies
      - Accountability mechanisms (clawbacks)
  - Heightened scrutiny of risk-management practices
    - Procedures and tools relevant for the specific business activities of the BHC
    - Articulation of risk appetite, and means for measuring and monitoring compliance with Board-approved strategies
    - Robust governance reviews and stress testing
  - Targeted, critical assessments of capital and liquidity management
    - Risk-based capital (with capital “cushions”)
    - Liquidity plans (including contingency funding plans)



# Bank Regulatory Oversight of Institutional Securities Activities

---

- **Regulatory concerns regarding Liquidity Management**
  - View that liquidity issues drove investment bank failures
  - BHC must maintain consolidated, as well as legal-entity based, picture of liquidity position and ongoing needs
  - Need for adequate and transparent mechanisms to
    - Evaluate portfolios and inventory
    - Govern mark-to-market protocols
    - Independently verify accuracy of pricing (mark-to-market), valuation
    - Identify and address market risk
    - Identify and address credit exposures
  - BHC operational risk controls to include collateral management
    - Knowledgeable of collateral held and posted, including triggers for increasing or decreasing amounts
    - Ability to access posted collateral



# Bank Regulatory Oversight of Institutional Securities Activities

---

- **Significant Limitations on Capital Market Activities**
  - Transactions with affiliates
    - Specific concerns around banks and BHCs, and related Section 23A issues
    - Cross-marketing restrictions
    - Anti-tying
  - Merchant banking restrictions
    - BHCs (but not banks) may make equity investments in non-financial companies
    - Limits on holding period
    - Section 23A and cross-marketing restrictions



# Legislative Developments – All

---

- **Regulatory Reform**

- High level overview of status of U.S. legislative reform initiatives
- Significant legal issues
- Anticipated impact on BHC compliance platforms