

CHALLENGES FOR OPERATING CROSS-BORDER INVESTMENT BUSINESSES: MEETING COMPLIANCE EXPECTATIONS ON A GLOBAL SCALE

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International Compliance Issues²

I. OVERVIEW: MEETING COMPLIANCE EXPECTATIONS ON A GLOBAL SCALE

In considering international compliance issues, there are two key points to keep in mind. First, there is a growing consensus that global regulatory convergence, while not a reality today, is a goal toward which national regulatory authorities should work. Second, while every national regulator is focused on the need to enhance investor protection and to oversee the conduct of investment firms, be they housed in a broker-dealer, a bank or an investment company, each regulator discharges its responsibility a little differently.

The shift toward regulatory convergence has and will continue to profoundly affect the governance of international financial institutions. Firms that are currently subject to multi-jurisdictional, and often conflicting, regulatory requirements must adapt to the fact that the various regulators promulgating and enforcing those requirements are moving toward a global, interactive relationship. The SEC/Euronext agreement, described below, is a prime example of this new reality. When considered in tandem with the broad reach of the EU Market Abuse Directive the message for global firms is clear: firms are facing an environment where international regulators are coordinating their efforts like never before, but where the dangers involved in navigating different attitudes toward enforcement on a case by case basis remains very real. To successfully implement and execute their business models in the global regulatory environment, firms must anticipate and prepare for the challenges posed by such an environment. Above all, a firm must be able to:

- demonstrate to regulators in multiple jurisdictions that it has established a tone at the top that reflects a commitment to compliance controls on a global level;
- demonstrate that those compliance controls enable the firm to identify and respond to issues in multiple jurisdictions; and
- remain cognizant that international regulators are coordinating and cooperating like never before, and that this affects the risk to the firm of being scrutinized by multiple regulators as well as the conduct of cross border investigations and enforcement efforts.

This outline will provide an introduction into practices which address these issues. The outline reflects important developments related to the EU Market Abuse Directive and Markets in Financial Instruments Directive.

II. NYSE EURONEXT, INC. - THE NEXT PHASE OF INTERNATIONAL REGULATORY COORDINATION

The rise of international regulatory coordination and cooperation has never been more evident than at present. On January 25, 2007 the U.S. Securities and Exchange Commission and the College of Euronext Regulators³ announced the signing of a memorandum of understanding (“MOU”) designed to

² This outline was prepared by Michael D. Mann and William P. Barry. Messrs. Mann and Barry are partners in the Washington, D.C. office of Richards Kibbe & Orbe, LLP. The views expressed in this outline are their own. This outline is for general information purposes only and does not represent legal advice regarding any particular facts. No part of this document may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or by any information storage and retrieval system, without permission in writing from the authors. Copyright © 2006 Michael D. Mann and William P. Barry. All rights reserved. Portions of this document may be used for other programs and publications, including *Developments in the Internationalization of Securities Enforcement*, *The International Lawyer*, Fall 2005 and Winter 2005 publications; Volume 39; numbers 3 and 4; ABA Section of International Law.

³ The authorities making up the College of Euronext Regulators include: Authority for Financial Markets (“AFM”), Netherlands; Autorite’ des Marche’s Financiers (“AMF”), France; Banking Finance and Insurance Commission

facilitate market oversight in anticipation of the combination between NYSE Group, Inc. and Euronext N.V. into NYSE Euronext, Inc. The agreement supplements existing multilateral and bilateral cooperation agreements among the parties to the agreement. The MOU is further evidence of the commitment of international regulators to cooperate and collaborate in developing, overseeing and enforcing a global system designed to promote investor protection, market integrity and maintain investor confidence and systemic stability. The MOU, which goes into effect upon publication by Euronext Paris S.A. of a declaration that the thresholds for acceptance of the NYSE Euronext offer have been reached, has been heralded by SEC Chairman Christopher Cox as reflective of “a modern approach to oversight of globally-active institution [that] underscores the intent of securities regulators on both sides of the Atlantic to work together to coordinate our supervisory efforts.” In addition, the MOU explicitly contemplates a continuing dialogue regarding the regulatory implications of further levels of integration of markets.

III. CONVERGENCE

Regulators have recognized the difficulties posed for global businesses by competing and conflicting regulatory schemes and have embraced the concept of “convergence.” In an October 7, 2004 speech at an international seminar sponsored by the American Bar Association International Securities and Capital Markets Committee of the Section of International Law, SEC Commissioner Roel Campos discussed the state of the convergence effort. He noted that the SEC is committed to “seeking to promote regulatory convergence across the globe at a very high level of standards and principles.” Mr. Campos discussed the impact of the Sarbanes-Oxley Act, which he described as an “emergency” measure, the international ramifications of which were not completely thought through when it was enacted in 2002. He stated that that the Act “was not intended to impose a trap, a surprise—impose our will on other jurisdictions.” While the SEC does not have the power to commit the U.S. to the establishment of an integrated Atlantic market, Mr. Campos noted that the goal of such a market is “far more reachable” due to the SEC’s efforts to achieve regulatory convergence.

SEC Chairman Christopher Cox reaffirmed the SEC's intention to promote regulatory convergence in an interview with The Financial Times published August 3, 2006. He noted the SEC's "very clear and strong interest in collaborating with our overseas counterparts for the simple reason that our capital markets are rapidly converging. Globalisation is hardly new. The only surprising thing is that it has taken this long for our capital markets to converge. Perhaps one reason for the delay has been the barriers posed by regulation. And yet unless regulators collaborate, their home investors will be unable to reap the benefits of lower trading costs, greater investment choice and broader opportunities for diversification." As recently as January 24, 2007 Chairman Cox summarized his view of the SEC's stance toward convergence, stating “[o]ur success will be measured not by the degree to which we close off other marketplaces from our own, but rather by the extent to which we more closely integrate our regulatory efforts as our markets become more closely connected.”⁴ This is the import of the SEC/Euronext agreement.

There are three separate approaches to convergence that are being pursued. First, the EU is developing directives that bring together the whole of Europe to meld one standard both of rule and enforcement with the hope of then coordinating with the rest of the world. Second, the U.S. is pursuing a “best practice” approach – attempting to lead through unilateral efforts. Finally, IOSCO is pursuing the traditional “consensus” approach to the topic. While all three approaches are aimed at the same goal – the improvement of standards -- this does not mean that there is one place for global businesses to look in conforming their compliance initiatives. Global businesses must implement compliance controls that are responsive to the differing concerns of regulators in multiple jurisdictions.

(“CBFA”, Belgium; Comissao do Mercado de Valores Mobiliarios (“CMVM”), Portugal; and Financial Services Authority (“FSA”), United Kingdom.

⁴ Address by Chairman Cox to the 34th Annual Securities Regulation Institute, January 24, 2007, “Re-Thinking Regulation in the Era of Global Securities Markets.”

The movement toward regulatory convergence, and the resulting improvement of regulatory standards imposed by national regulators, means that the firm is exposed to greater risk of scrutiny from regulators in multiple jurisdictions. It means that regulators know more about the firm's global business and are more focused on how events in one aspect of the business, be it local or extraterritorial, impact the overall business. It means that senior level personnel must view the firm as a single entity rather than a confederation of entities spread across the globe. It means the firm must have existing relationships with regulators in multiple jurisdictions, because those regulators will be communicating with one another and scrutinizing the firm. This last point is evident in the manner in which the international regulatory community has reacted to recent crises.

A. Examples of the Move Toward Convergence

Examples of the move toward convergence include the EU Market Abuse Directive, the adoption and ongoing efforts to implement the EU Markets in Financial Instruments Directive, ongoing efforts of the EU to regulate conglomerates, and the effort to regulate global credit-rating agencies and auditors. These initiatives are summarized below.

The Market Abuse Directive

The Market Abuse Directive ("MAD") was implemented in the UK on the 1st July 2005. It defines a broad range of behavior that will be considered to constitute market abuse, namely insider dealing and market manipulation. It applies to any financial instrument admitted to trading on a regulated market, or those where a request for admission to trading has been made. Consequently, it impacts securities firms, banks conducting securities business, alternative trading systems, recognized investment exchanges, and listed companies.

The impetus behind MAD is the creation of an EU-wide market abuse regime based in greater cooperation and exchange of information between national regulators. Consistency in enforcement efforts by regulators will lead to less confusion and more equal treatment for those affected by MAD. MAD is not unlike §10b of the U.S. Securities Exchange Act, but broader. Firms must be cognizant of the potential ramifications of this broader authority.

Article 12 of MAD requires securities regulators in each EU Member State to have all subpoena and investigatory powers necessary for the exercise of its function, including the power to compel information, seek asset freezes, conduct on-site inspections and suspend trading in securities. While the Financial Services Authority ("FSA") already had these powers in place, many other EU regulators currently conduct partial investigations, then refer the matter to criminal prosecutors.

One of the most important new requirements for the UK regime resulting from MAD is the requirement to report suspicious transactions. Firms arranging transactions are required to report those transactions to the relevant competent authority (in the UK the FSA) where there is a reasonable suspicion that market abuse might have taken place. Following the implementation of MAD, from July 2005 to January 2007 the FSA has received 290 suspicious transaction reports. As a result of further work conducted based on these suspicious transaction reports, a number of them have resulted in enforcement investigations. Suspicious transaction reports are one of the key intelligence assets at the FSA's disposal and their quality is important to the enforcement effort, not least because firms understand their clients best and can best identify suspicious behavior. For this reason the FSA has emphasized the responsibility of market participants to work proactively to preserve the integrity of the markets.

While the implementation of MAD has afforded EU-based regulators the opportunity to develop a cooperative enforcement framework, global firms still face uncertainties in the enforcement context. It is sometimes unclear which EU member's regulatory body will function as the lead investigator, or whether multiple regulators will conduct concurrent investigations of a particular transaction or event. Moreover, firms may be placed in a situation where they must forecast the degree to which the actions of one

investigating regulatory body might influence the decisions of other bodies with respect to either investigation or ultimate determinations on the merits.⁵

The Markets in Financial Instruments Directive⁶

The Markets in Financial Instruments Directive (“MiFID”) is designed to create a single EU market in financial services. The FSA has made the deadline of 31 January 2007 for transposing MiFID. The switch-on date for MiFID and the new Handbook text is 1 November 2007, allowing a nine-month period following transposition for financial institutions to complete their plans for implementation of the new MiFID requirements.

MiFID replaces and expands the coverage of the ISD and requires significant changes in the way firms conduct business and organize their operations. Firms that will be subject to MiFID include:

- Investment banks;
- Portfolio managers;
- Stockbrokers and broker dealers;
- Corporate finance firms;
- Many futures and options firms; and
- Some commodities firms.

Retail banks and building societies are subject to MiFID for some parts of their business, such as selling securities or investment products which contain securities.

One object of MiFID is to clarify the responsibility between home state and host state for passported branches. MiFID contemplates, for example, that a firm providing cross-border services from its home state into another Member State are subject to home state requirements.

MiFID results in significant changes impacting financial services firms. The range of ‘core’ investment services and activities that can be passported are broadened to include personal recommendations to a core investment service; operating a multilateral trading facility; commodity derivatives, credit derivatives and financial contracts for differences.

Firms subject to MiFID must adapt their business conduct and compliance regimes to account for changes in a variety of areas, including the following:

- (a) Compliance with the new Capital Requirements Directive, which sets requirements for the regulatory capital a firm must hold.
- (b) Organizational requirements impacting compliance arrangements, internal systems and controls, outsourcing, record-keeping, management of conflicts of interest, and safeguarding of client financial instruments or money held by firms.

⁵ These issues are explored in detail in recent articles by David Mayhew and by Carlos Conceicao. Mr. Mayhew, formerly with the FSA, has written an article entitled *Market Abuse: Developing a Law for Europe*, European Company Law; October 2006; Volume 3, Issue 5. Mr. Conceicao, currently with the FSA, has written an article entitled *Tackling Cross-Border Market Abuse*; Journal of Financial Regulation and Compliance; Volume 14, No. 1; 2006.

⁶ Information for this section was obtained from the FSA’s website at <http://www.fsa.gov.uk/Pages/About/What/International/EU/fsap/mifid/index.shtml>. For a more detailed discussion, see FSA’s publication *Planning for MiFID* (November 2005.)

- (c) Conduct of business standards including a new client classification regime.
- (d) Best execution requirements including the requirement that firms consider not just price, but other factors such as cost, speed and likelihood of execution and settlement.
- (e) Passporting rights changes that permit firms to establish branches in other member states and offer a wider array of cross-border services.
- (f) The establishment of a common EU framework for classifying counterparties between professional clients, market counterparties and retail clients.
- (g) The establishment of new minimum standards for regulated markets and multilateral trading facilities.
- (h) The establishment of pre-trade equity transparency standards for shares traded on regulated markets and multilateral trading facilities. In addition, an investment firm that is a "systematic internaliser" must undertake definite bid and offer quotes in liquid shares for orders below "standard market size."
- (i) The establishment of post-trade equity transparency for all types of trading in shares, whether on regulated markets, multilateral trading facilities or over the counter.
- (j) Post-trading reporting requirements whereby reports are made to the competent authority of the home/host state of firms and not the competent authority of the regulated markets on which the instrument is traded. This requirement is broadened to include required transaction reports for any instrument admitted to trading on a regulated market, including commodity instruments admitted to trading on exchange.

EU Financial Conglomerates Directive

The Financial Conglomerates Directive contemplates the supervision of financial conglomerates and financial groups involved in cross-sectoral activities to improve the stability of the European Economic Area ("EEA") financial system.

The main objectives of the Directive are the following:

- (k) To ensure that financial conglomerates are adequately capitalized, preventing the same capital being counted twice over and so used simultaneously as a buffer against risk in different entities;
- (l) To introduce methods for calculating a conglomerate's overall solvency position; and
- (m) To provide for the establishment of a single lead regulator for financial conglomerates, rather than multiple lead regulators as at present, thereby reducing regulatory duplication

The provision in the Directive for establishing a lead regulator has generated significant controversy, particularly as applied to firms headquartered outside the EU. The Directive provides for

one regulator to have primary supervision responsibility for the conglomerate as a whole, rather than multiple regulators being equally responsible for their respective areas of focus, e.g. investment banking or insurance. With respect to investment banks operating in the EU that have ultimate parents located outside of the EU, financial conglomerates must be subject to consolidated global supervision by the home country regulator of the parent, provided that such supervision is determined to be "equivalent" to the type of supervision provided by the EU regulator otherwise in a position to regulate the investment bank. It is not difficult to imagine the potential difficulties posed by the prospect of an EU regulator evaluating, for example, whether the SEC's level of supervision is equivalent to the EU regulator's standards, then requiring that an investment bank be supervised, conglomerate-wide, by the SEC.

The EU approach has created pressure on the SEC because of the cross over impact on U.S. registrants. In the example provided above, if the SEC were not found equivalent, the regulated investment bank would have to undertake one of the following steps:

- (a) Submit to a U.S. regulator deemed equivalent;
- (b) Submit to EU consolidated supervision; or
- (c) Create an EU holding company for European activities to segregate EU firms and non-EU affiliates.

B. Reaction to U.S. Initiatives: Sarbanes-Oxley and the USA-Patriot Act

The efforts of the U.S. to increase its extraterritorial reach through the Sarbanes-Oxley Act ("SOX") and the USA-Patriot Act to issuers and market participants who engage in conduct in the U.S. from abroad have, somewhat ironically, both contributed to its perception as a unilateral regulator while substantially adding standards on which there is a growing world consensus -- the movement toward convergence. Regulators outside of the U.S. have reacted forcefully to what has been perceived as overreaching on the part of U.S. regulators.

In response, foreign regulators have developed more aggressive regulatory initiatives both in the accounting and conglomerates area, such as the EU's Financial Conglomerates Directive discussed above at §0. While the EU's efforts have advanced the development of higher standards and thus increased the chance for convergence, they too have not been met with enthusiasm by U.S. regulators. While as a matter of policy global firms should look at the U.S. approach to SOX and the Patriot Act as laying the groundwork for convergence, the standards address issues that are still being separately enforced by regulators in multiple jurisdictions. Enforcement and oversight remain uneven and for an international financial institution, the cost of compliance goes up because, while in principle there is one standard, the institution is constantly responding to every local regulator.

The Sarbanes Oxley Act

With few exceptions, SOX requires that all companies listed on U.S. securities exchanges or traded in the Nasdaq Stock Market are subject to the Act. In the Final Rule: Standards Relating to Listed Company Audit Committees, Rel. Nos. 33-8220, 34-47654 and IC-260001 (Apr. 9, 2003) the SEC stated that "[w]ith the growing globalization of the capital markets, the importance of maintaining effective oversight over the financial reporting process is relevant for listed securities of any issuer, regardless of its domicile." As a result of complaints from the international community during the rules comment process, there have been some exceptions made for circumstances where the domicile of a foreign-based issuer might have legal requirements and standards that conflict with SOX. While the Act includes the possibility for exemptions, acknowledging the differing regulatory systems in which a global firm operates, the SEC has been reluctant to rely on it.

The USA-Patriot Act

The USA-Patriot Act is an example of the U.S. setting the standard with respect to money laundering compliance, and expecting the rest of the world to follow. The Act's anti-money laundering regulation has drastically altered the way firms do business. For example, where in the past a firm might have thought little of establishing extraterritorial accounts and transferring funds to and from different jurisdictions for a variety of business purposes, a firm must now carefully analyze such transfers for compliance with its regulatory obligations.

As a result, firms are revisiting virtually every component of how accounts are opened and reviewed to improve the chances that inappropriate business is turned away and that suspicious activity is uncovered. With respect to foreign clients, the OFAC review will only be the beginning of a process of due diligence, not the end. Similarly, the risks associated with opening and maintaining an account for a client located outside of the U.S. will no longer be limited to potential foreign prosecution, but now may be more likely to include close scrutiny, if not worse, from regulators and enforcement authorities in the U.S.

The USA-Patriot Act requires financial institutions, including broker-dealers and unregistered investment companies, to implement anti-money laundering compliance procedures. The Act does not provide for mutual recognition with respect to similar regulation in other jurisdictions.

C. IOSCO

IOSCO has spearheaded the effort to achieve convergence using a traditional, "consensus" approach. As discussed below, several IOSCO initiatives hold the promise of reducing the cost of compliance for global firms by setting uniform standards.

Credit-Rating Agencies

On January 9, 2006, the European Commission adopted a communication setting out its approach to credit rating agencies. Citing advice received from the Committee of European Securities Regulators ("CESR") in March 2005, the European Commission announced its view that existing financial services Directives applicable to credit rating agencies, combined with self-regulation based on the "Code of Conduct Fundamentals for Credit Rating Agencies" published by IOSCO on December 23, 2004, obviated the need for additional legislative proposals in this area. In connection with the communication, Internal Market and Services Commissioner Charlie McCreevy noted that the European Commission intended to ask CESR to monitor the credit rating agencies' compliance with the Code and to report back regularly. He stated that "[i]n short, the rating industry remains "on watch" and will be monitored."

The purpose of the 2004 "Code of Conduct Fundamentals for Credit Rating Agencies" published by IOSCO is to provide for broader global regulation of the rating process in order to enhance investor protection. In its release, IOSCO described the Code as a "global converged view of specific mechanisms CRAs can use to protect their analytical independence, eliminate or manage conflicts of interest, and help ensure the confidentiality of certain types of information shared with them by issuers."

Mr. Andrew Sheng, the Chairman of the IOSCO Technical Committee, said in the IOSCO release that "The essential purpose of the Code Fundamentals is to promote investor protection by safeguarding the integrity of the rating process. IOSCO expects all CRAs to give full effect to the Code Fundamentals. The reason we devoted so much effort to this policy area is because we recognize the importance of reliable and accurate credit ratings in helping investors assess the credit risks they face when making investment decisions."

Mr. Roel Campos, an SEC Commissioner who also chaired the IOSCO task force that drafted the Code, said that the decision to develop a Code that CRAs would incorporate rather than sign onto

was based on the need for flexibility. He stated that “We believe this approach is more flexible and more effectively enforced than would be the case if IOSCO had drafted a universal code for all CRAs to sign onto.” The IOSCO release cites as a factor in this decision the recognition that “CRAs vary considerably in size, business models, rating methodologies and the legal and market circumstances in which they operate.”

Among its provisions, the Code contains a disclosure mechanism that requires CRAs not only to incorporate the provisions, but also to explain how each provision is addressed. The Code provides that in instances where a CRA does not incorporate all provisions contained in the Code, it is expected to disclose why it has not incorporated the relevant provision and how the objectives of the provision are otherwise addressed.

The Code addresses the following issues:

- (a) Quality and integrity of the rating process
- (b) CRA independence and avoidance of conflicts of interest
- (c) CRA responsibilities to the investing public and to issuers
- (d) Disclosure of the Code of Conduct

Continuing IOSCO Efforts

In a May 18, 2004 press release, IOSCO highlighted the focus of a task force formed to respond to high-profile incidents of securities fraud and market abuse. The areas identified by IOSCO are listed below:

- (e) Corporate governance, including the role of independent directors on an issuer’s corporate board, the rights of minority shareholders, and mechanisms (including the enforcement of accounting principles) to protect against conflicts of interest presented by related-party transactions;
- (f) Auditor oversight, including auditor independence, the effectiveness of audit standards and supervisory activity, the role of independent board committees, and issues related to mandatory auditor rotation;
- (g) Regulatory oversight, such as the nature and effectiveness of financial and non-financial disclosure requirements, issues relating to regulatory gaps resulting from the multiplicity of regulators, cross-border and domestic regulatory information-sharing, and the transparency and regulation of corporate bond markets;
- (h) The use of complex corporate structures, including complex financial and shareholding structures and the use of special purpose accounting vehicles, and whether their use poses particular regulatory issues;
- (i) The role of market intermediaries and gatekeepers, such as investment banks, lawyers and broker-dealers, and the types of due diligence obligations they may have and to whom these obligations are owed;
- (j) The role of private-sector information analysts such as securities analysts and credit rating agencies and the degree to which these

analysts can, do or should play a role in detecting issuer vulnerabilities and their conflicts of interest; and

- (k) Offshore financial centers and whether and to what degree “under-regulation” and “non-cooperation” in these jurisdictions can pose problems for effective market oversight, taking into account the internationalization of securities markets.

IV. SETTING THE GLOBAL TONE AT THE TOP

The “tone at the top” is a phrase that has come to exemplify the benchmark by which all enterprises are today evaluated. It is critical that firms establish a strong, global tone that reflects a commitment to sound controls throughout the enterprise. Firms cannot view themselves as a confederation of entities, because that is not how they will be viewed by international regulators. The scandals involving global companies such as TV Azteca, Parmalat and Enron have resulted in scrutiny by regulators in multiple jurisdictions. Regulators are working together, and looking beyond their respective borders. The increased focus on increased communication and cooperation poses new challenges for operating a global securities firm. For example, cross border sales often implicate the need for registration. It is therefore vital that firms understand what requirements exist for which countries at the outset of a firm’s operations in those countries. In this way the firm can structure its sales activities in such a way as to address jurisdictional requirements related to registration and solicitation and tailor compliance initiatives to particular jurisdictions.

A firm must be vigilant in monitoring the regulatory requirements in each jurisdiction in which the firm operates, or in which its customers are located or do business. This is because controls deficiencies in any single part of a firm can have reverberations for the entire global enterprise. Regulatory authorities are interested in how management is filtering rules and setting a tone at the top that fosters effective global compliance. The difficulties experienced by Citigroup in Japan are an example of the trouble that can ensue when a global business fails to set a global tone. The Japanese Financial Services Agency ordered Citigroup to close its private banking business in Japan. Among other issues, the FSA found that bankers failed to take sufficient steps to guard against money laundering transactions. The company’s failure to identify potential compliance issues in its Japanese location, and to deal effectively with Japanese regulators, had serious repercussions, including alienating the regulators and the Japanese government. On November 30, 2004, the new head of Citibank Japan was called before the Financial Affairs Committee of the upper house of parliament and told by one lawmaker “We are not a territory of the United States. It’s not acceptable to show the kind of arrogance whereby you do anything you please in Japan. We are an independent country and our rules are the rules.” *The New York Times*, “Bows Just the First Move for a Bank Out to Regain Face,” Zaun, Todd (Dec. 28, 2004.)

Since Citigroup’s well-publicized problems in 2004, there has been no sign that international regulatory authorities are relaxing their efforts. In January 27, 2006, the Japanese Financial Services Agency published an Administrative Action regarding State Street Trust and Banking Company, Limited. In suspending State Street from engaging in new trust business for the period of February 6, 2006 through March 5, 2006, the FSA cited shortcomings in State Street’s governance and compliance systems, including staffing and the need to construct “a proper organization and structure,” as well as the need to segregate areas of business and introduce a proper customer information management and control system.

Depending on the structure of a firm, day-to-day control over the internal organization of the firm may reside at the local or central level. Ultimately, however, from a business risk standpoint it is critical to establish centralized control/reporting with respect to the firm’s global business. Only then will a firm have an adequate grasp on its regulatory exposure. With such centralization, a firm can properly identify international compliance issues, train its personnel appropriately, and address issues effectively. In effect, it provides the firm the ability to set and maintain the appropriate “tone from the top” and ensure

that the proper controls exist on a firm-wide basis. This is not to say that the firm should not adapt to local requirements, but it must have the means to issue spot on a global level and be able to communicate effectively within the organization to address these issues.

A. Establishing a Business that Prospectively Takes into Account Potential Regulatory Issues

The firm must assess and effectively address its regulatory exposure on a global basis. Knowing the reach of applicable regulation, building and maintaining a compliance infrastructure, developing relationships with regulators and monitoring regulatory initiatives are key components of this effort.

An effective means for keeping a firm in compliance may be establishing relationships with local counsel in order to develop a full understanding of applicable laws. This will help to guide the firm's marketing and business activities and assure the firm's compliance with the laws of each country in which the firm operates. Maintaining a central database of information, updated regularly, regarding the legal and regulatory implications of various types of communications to prospects and customers and of visits to a particular country, for instance, would foster compliance.

B. Building Relationships With Regulators and Monitoring Regulatory Initiatives.

It is critical that a firm establish relationships with the regulatory authorities that can directly affect its business. An established line of communication is the first line of defense and can do much to prevent escalation of a regulatory issue to the point where it impacts the firm's business. Management should assume that regulators in multiple jurisdictions are communicating about the firm and are aware of regulatory issues affecting the firm throughout its locations. Management should assume that the regulators know more about the international regulatory community's view of the firm than management does. In turn, management should ensure that regulators know that the firm has a global tone at the top, robust, global compliance procedures, and is committed to identifying potential regulatory issues and changing its processes to improve compliance. Communication is key. A plan designed to foster relationships with regulators and monitor regulatory initiatives might include the following action items:

Designating specific individuals within the firm who are responsible for outreach and coordination with the firm's regulators in markets in which the firm does business is critical to establishing consistency and control. The firm should have a global compliance contact in addition to local compliance personnel. There must be open, frequent communication among compliance personnel at the global and local levels.

Creating a channel for communication will permit the firm to stimulate its regulators' thinking about issues and innovations that are important to the firm's business. Communications with regulators are best made outside of the context of enforcement actions.

If compliance with regulators' document and data requests is centrally coordinated, the firm is better able to comply with applicable privacy and other country-specific rules, such as data protection requirements.

Monitoring regulatory initiatives is essential. Increasingly, national regulators are working together under the auspices of organizations such as (IOSCO) to develop new initiatives, as well as to coordinate regulatory and enforcement efforts.

V. COMPLIANCE CONTROLS FOR THE GLOBAL FIRM

The challenge in developing compliance controls and procedures is in making sure that the controls are universal throughout the business, and that communication within the firm allows management to issue-spot, address potential issues, and communicate proactively with regulators. Robust, global initiatives in training, reporting and testing are the mechanisms through which the firm can be in a position to understand and address its risks. These efforts should focus on the following core areas.

A. Effective Monitoring of Customer/Business Relationships

An effective process must be in place for identifying, at the time the firm processes account-opening documentation, for instance, whether another country's laws may apply. Potential foreign clients, particularly those wealthy and sophisticated enough to seek to establish U.S. accounts, provide tempting business opportunities. They also present substantial risks for compliance to identify, evaluate and address. These risks include:

Impact on a firm's ability to do business in another country. A country in which a firm inadvertently becomes subject to regulation today may later become the country into which the firm affirmatively wants to enter. A regulator may regard a firm's initial failure to register as indicative of the firm's fitness (or lack thereof) to do business in the jurisdiction.

The possibility that transactions may be void or voidable in the foreign country. A firm that sells an unregistered product may be effectively indemnifying the purchaser against future losses.

The actions of a foreign regulator or court can affect a firm's U.S. status. A result of the growing level of coordination and cooperation among national regulators may be that compliance problems that originate at the local level may become international issues for the firm – and a focus of the firm's key regulators. In addition, an action taken by a foreign court or regulatory authority can provide the SEC the same basis for statutory disqualifications as the actions of U.S. courts and regulators.⁷

B. Effective Monitoring of Brokers' Outreach Efforts

Unless these efforts are supervised appropriately, the firm may find itself in a position of turning away business its brokers have solicited.

C. Effective Monitoring of Compensation to Non-registered Persons

The internationalization of the securities markets has increased the possibilities for U.S. firms to attract foreign clients. U.S. firms are increasingly using foreign, unregistered "finders" to identify and direct business to the U.S. firm. Indeed, the NYSE and the NASD have set out specific rules that contemplate payments to these "finders." Where this is done, however, it is critical that extreme care is taken to ensure that (a) the finder is both foreign and not otherwise associated with the U.S. firm; (b) the investor is one contemplated to be covered; (c) the compensation to be paid the finder is appropriate; and (d) the appropriate consent from the customer has been obtained. See: NYSE Rule 345, NASD Rule 1060.

⁷ Sections 15(b)(4)(B), (C) and (G) of the Securities Exchange Act of 1934 provide grounds for the SEC taking action against a broker or dealer based on (B) violations of foreign criminal laws, (C) an injunction from a foreign court or (G) findings by a "foreign financial regulatory authority." The same potential reliance on foreign proceedings also applies to individuals. Section 15(b)(6)(A). The U.S. SROs have similar provisions regarding foreign actions.

D. Effective Monitoring of Advertising and Other Information Dissemination, Including Electronic Communications

Global name recognition can, in the regulatory context, result in greater liability.

E. Effective Monitoring of All Global Expansion Efforts

The firm's acquisition staff should be well-versed in, or well-advised regarding, international regulatory issues.

F. Guarding Against Conflicts of Interest in a Global Business

Since September 2003, when the SEC Division of Enforcement announced its intent to focus on the "conflicts crisis" in the financial services industry, SEC regulated firms have had to reexamine the multiplicity of interests behind their ever-expanding businesses. The issue of conflicts of interest had special relevance for global firms both because of their size and their overlapping and often competing internal national networks. The focus on conflicts of interest has had a profound effect on the attitude of international regulators with respect to these issues. The risk posed for firms as a result of the regulators' focus on conflicts increases exponentially when one factors in the need to examine a business not just by business area and with respect to U.S. regulatory requirements, but also by location and with respect to multiple regulatory requirements imposed by regulators in multiple jurisdictions. Moreover, global businesses must be cognizant of the fact that regulators from multiple jurisdictions will be examining not only the conduct of local entities, but the manner in which the firm as a whole is addressing the issue and coordinating its compliance procedures globally.

Examples of conflicts of interests that have become touchstones for global regulators, including the following:

(a) Analysts

- Inappropriate pressure on research analysts to issue positive research about the firm's investment banking clients;
- Payments to firms for the creation of research without disclosing the payments;
- Failure to disclose conflicts on the part of the individual research analyst, e.g. ownership of stock;
- Issuing recommendations inconsistent with the analyst's privately held views.

(b) Registered Representatives

- Steering clients to mutual fund shares that lead to higher commissions for the registered representative;

(c) Investment Advisers

- Failure to disclose the fact that the adviser received client referrals from brokerage firms, then used those firms to execute their client's trades;
- Preferential allocation of "hot" IPOs by investment advisers.

- Conflicts between investment banking and investment advisory businesses housed within a single firm;
 - (d) Conflicts identified as “on the radar”
 - (i) Instances where business areas, other than the investment banking area, of full-service firms seek to influence the content of a firm’s research.
- Conflicts between the firm’s equity sales and trading desk and the research area in the event that a particular equity is downgraded by a research analyst at the firm after the firm recommended and sold the stock to a client;
- Conflicts between the firm’s proprietary interest in a company and the view of the company by the research group;
- Conflicts between the firm’s asset management group and the research group when a research analyst considers downgrading a particular stock that could impact the asset management group by negatively affecting 401K or other investment vehicles managed by the asset management group;
- Instances where asset managers are pressured into investing in companies that its investment banking affiliate had underwritten;
- Undisclosed arrangements between pension consultants and broker-dealers;
- Allocating redemptions among holders of callable bonds;
- Allocation among customers when a broker-dealer or investment adviser bunches customer orders and allocates among customers after execution;
- Sales practices in the mutual fund area; and
- Conflicts in situations where firms invest in hedge funds.

Potential for Coordination

One result of the increased global focus on conflicts of interest is that there is an opportunity for regulators in multiple jurisdictions to coordinate efforts. Since regulators in multiple jurisdictions are examining these issues with similar objectives in mind – reduction of conflicts of interest and remediation or better disclosure where those conflicts are found. Increased communication among regulators and coordinated enforcement strategies would benefit firms as well, reducing the cost of compliance by reducing the need to individually tailor compliance initiatives by location.

Regardless of the state of communication among regulators, global firms must set a tone and develop compliance controls that account for the fact that there are multiple regulators in multiple jurisdictions potentially reviewing the firm’s conduct.

U.S. and Non-U.S. Rules Regarding Research Analysts

One outgrowth of the increase in the regulation of research analysts has been to further complicate compliance efforts by foreign affiliates of U.S. firms and other non-U.S. entities. At the same time, regulators in other jurisdictions have also begun to legislate for or supplement their existing regulations in relation to investment research, in some cases proposing to, or in fact going further than the various U.S. rules. The U.S., U.K. and IOSCO have undertaken substantial initiatives to regulate research analysts. However each has taken a different approach. As a result, there is no single, unified standard to guide firms in establishing and implementing compliance procedures.

Recent U.S. rule changes designed to address potential conflicts of interest relating to research illustrate the difficulties posed for global firms by differing or competing regulatory regimes. On July 29 2003, the Securities and Exchange Commission (the "SEC") approved rule changes filed by the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange ("NYSE") that restrict and prohibit certain activities of firms and their analysts in relation to equity research. The SEC has also adopted Regulation AC, which is wider in scope, and their combined effect is to impose additional requirements on firms and their research analysts. Additionally, the Global Settlement reached between the SEC and other regulators and ten of the largest US investment firms includes a series of wide-ranging undertakings by those firms in relation to their investment research and analyst arrangements.

G. Sales Issues: An Example of the Challenge of Implementing Compliance Initiatives Across a Global Business

Cross border business begets cross border regulatory obligations. The issues relating to sales by a global broker-dealer provide examples of some of these challenges. Regardless of whether a firm perceives itself as a participant in international markets, the appropriate inquiries for purposes of regulatory analysis are where the firm's customers are located and how the firm obtained their business. A customer's location or conduct can implicate international regulatory obligations with regard to a domestic sale or account. For example, if a firm accepts the business of a customer resident in a country where the firm is not registered, it may be subject to that country's regulations. In addition, the sales personnel in the overseas branch or affiliate office of a U.S. firm may be regarded as operating on behalf of the "brand" and their activities may be attributed to the U.S. parent.

Doing business over the Internet or with non-U.S. customers temporarily present in the United States also can make a firm subject to another country's laws, regardless of whether the firm has a base of operations there. The international regulatory community is focused on this issue. See, *In the Matter of the Securities Legislation of British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, Nova Scotia, New Brunswick, Newfoundland, and Yukon*, where the British Columbia Securities Commission, acting on behalf of each Canadian Provincial securities authority, obtained a consent by Ameritrade to a fine of \$800,000 and registration by Ameritrade in each Canadian Province. The basis of the case was that Ameritrade permitted residents of Canada to open accounts and executed orders for those residents without being registered in each province.

Regulatory Requirements

(a) Issues for U.S. firms.

U.S. firms must determine whether they are conducting business abroad in ways that may require registration in other jurisdictions. The relevant analysis may turn on both factual and legal considerations and usually requires the advice of foreign lawyers in a particular jurisdiction. Relevant factors may include the way in which the account was established (solicited versus unsolicited), the nature of the client (for example, small retail investors versus high net worth individuals) and the overall number of clients in the particular country.

(b) Issues for foreign firms.

- (i) If a firm is not registered in the United States, the firm's contacts with U.S. customers must be within the bounds of Rule 15a-6, an exemptive rule promulgated under Securities Exchange Act of 1934. Note that the SEC is on record as stating that it is considering a global modification of the Rule. Among other things, the SEC is actively considering a cap on the number of "unsolicited transactions" a given foreign broker-dealer can

effect within a specified time frame and still rely on the Rule's exemption from registration.

- (ii) Any fee-splitting arrangement that a foreign firm has with an NASD member firm must comply with the requirements of NASD Rule 1060 so that the foreign firm can avoid being subject to regulation as a U.S. broker-dealer. Similarly, such arrangements with New York Stock Exchange members and member organizations must comply with NYSE rules that permit payment of transaction-related compensation to non-registered foreign finders.
 - (iii) While historically the fees charged by the trust department of a bank have not been viewed as coming within the ambit of the federal securities laws, the Gramm-Leach-Bliley reform legislation has changed the landscape significantly. In particular, there are now specific thresholds for compensation that a bank conducting the equivalent of traditional brokerage activities can receive before it must register as a broker-dealer. Foreign banks, as well as U.S. brokerage firms with foreign subsidiaries, which in the past have regarded themselves as exempt from SEC regulation, must be vigilant to ensure that they implement rules to ensure that their traditional trust business does not inadvertently become subject to broker-dealer regulation based on the manner in which it is compensated for its services.
- (c) Of course, once an account is established, both U.S. and foreign firms must continue to monitor the activity in the account in order to detect changes in activity or status that could implicate money laundering concerns.
- (d) Account Opening Due Diligence
- (i) A firm must assess whether account opening documents – as well as account maintenance forms – effectively identify where sales can be made and whether the prospective account location is appropriate in light of the prospective account-holder's residency. Establishing new accounts over the Internet, rather than face-to-face, raises special issues. The SEC's 1998 Internet release suggests that the firm ascertain the Internet customer's residence by obtaining such information as mailing addresses or telephone number (or area codes) prior to the sale. The release further indicates that the firm should be alert to the following, which may put the firm on notice that the purchaser is a U.S. person: provision of a U.S. taxpayer identification or social security number, or statements by the purchaser indicating that, notwithstanding a foreign address, he or she is a U.S. resident.
 - (ii) Source of funds should be used as a further check on sales — e.g., whether payment is drawn on a bank operating in a country in which the firm is not aware that the prospective client is doing business. The SEC's Internet release indicates that receipt of payment drawn on a U.S. bank should put an Internet offeror on notice that the purchaser may be a U.S. person, and

should cause the offeror to take steps to verify that the purchaser is not a U.S. person before selling to that person (e.g., making a request for a copy of a passport or driver's license). Additional issues regarding source of funds arise in the context of anti-money laundering efforts. For instance, in the U.S. the Patriot Act requires "know your customer" compliance that in some instances conflicts with regulation in other jurisdictions. This issue is discussed below at (iii).

(iii) Customer Due Diligence

Know your customer requirements constitute the core component of a company's commitment to deterring money laundering. This generally means obtaining reasonable information about both clients and beneficial owners and performing reasonable follow up diligence. This information should include, at a minimum:

- The identity of the client and beneficial owner of the account;
- The nature of the client's and beneficial owner's business;
- The source of the client's and beneficial owner's assets; and
- The intended purpose of the client's and beneficial owner's transactions.

(iv) In addition to the sales and solicitation and cross border trading issues discussed above, foreign accounts, including accounts for persons who are not U.S. citizens and accounts for clients who are located outside of the U.S., implicate anti-money laundering concerns. Companies should implement policies and procedures designed to address the requirements implicated by circumstances such as the following:

- Doing business with persons located outside of the United States.
- Opening an account for a non-U.S. citizen or a person with a foreign address.
- Maintaining an account when a client moves to a foreign country or from one foreign country to another.
- Maintaining an account that conducts transaction in one or more jurisdictions included in the OFAC or Non-Cooperative Countries and Territories Lists.
- Maintaining an account that conducts transactions involving a foreign shell bank or correspondent account.
- Transactions by senior foreign political figures or their close associates.

(v) To reduce some of the administrative burden, the firm may be able to integrate these back-office procedures with its money laundering detection procedures or other procedures involving a regular review of incoming payments and communications with

clients. Doing so may be particularly helpful in flagging a client who has relocated to another jurisdiction subsequent to opening an account with the firm.

- (vi) To further assist a firm in ensuring that sales are conducted through appropriate accounts, a firm should effectively monitor and direct its outreach efforts.
- A firm must consider its use of advertisements. A multi-office firm, in particular, should consider carefully whether its advertisements will be viewed as soliciting business for its global “brand” or just for the locally-registered branch.
- The IOSCO Report regarding Securities Activity on the Internet⁸ suggests a range of precautions that, when taken in connection with Web site offers/advertisements, regulators should view as reasonably designed to prevent conduct of brokerage business with residents in a particular regulator’s jurisdiction. Among these are the following:
 - Prominent Web site disclaimers/statements that clearly state to whom the Internet offer is directed, rather than appearing to extend the offer into any jurisdiction.
 - Back-office compliance procedures that ensure that services are not provided to any potential customer that the firm has reason to believe, based on the person’s statements or otherwise, is a resident of a jurisdiction in which the firm is not authorized to offer its securities or services.
- The IOSCO Internet Report suggests that assertions of jurisdiction may be appropriate for Internet advertisements or offers that have prices denominated in local currency or communications written in local language, when that currency or language is not commonly used on a global basis, or that are disseminated by e-mail or other media that “push” the information to residents of a particular jurisdiction. Substantially similar concerns are implicated by off-line advertising (e.g., in print publications or television).

Further, the firm’s use of a “banner” advertisement on a Web site with a primarily foreign readership will increase the likelihood that a regulator will review the offer as directed at foreign investors. For example, if a U.S.-based Internet offeror advertised its Web site (containing information about the offer) on a Web site intended for a British audience, the U.K.’s Financial Services Authority may conclude that the offer is directed at U.K. investors.

VI. CROSS BORDER INVESTIGATIONS AND ENFORCEMENT ISSUES: RAMIFICATIONS OF THE MOVE TO REGULATORY CONVERGENCE

The shift toward convergence and the increased communication among international regulators has resulted in more effective mechanisms for regulators to obtain information regarding extraterritorial business operations. Regulators now have the tools to see inside the firm and obtain information from foreign affiliates. This fact makes it even more important that the firm management be

⁸ International Organization of Securities Commissions, Securities Activity on the Internet, A Report of the Technical Committee of the International Organization of Securities Commissions (September 1998), available at <http://www.iosco.org/docs-public/1998-internet_security-document01.html>.

ever mindful of setting the appropriate global tone and establish compliance controls as described above. The IOSCO MOU, discussed below, is an example of the direction in which international information sharing among regulators is heading. This section also discusses some of the risks resulting from the fact that, despite the movement toward convergence, differences among regulators still exist. For example, secrecy and privacy concerns remain significant challenges. The bottom line is that the firm should assume that regulators will eventually gain access to the information they seek.

A. International Cooperation in Information Gathering: the IOSCO MOU

A Memorandum of Understanding (MOU) between the SEC and a foreign regulator will facilitate cross-border information gathering and may empower a regulator to conduct an on-site inspection of a firm in the other country.⁹ In recent years, the SEC's Office of Compliance, Inspections and Examinations has been conducting coordinated examinations of investment advisors overseas on a fairly routine basis.

The IOSCO MOU provides another powerful tool for international information gathering. Firms cannot afford to underestimate the degree to which the SEC or a foreign regulator can utilize the MOU to gain transparency into the firm's operations in a foreign jurisdiction. The MOU constitutes a redoubling of efforts to facilitate the access to and collection of information from foreign jurisdictions. The MOU is broad-based, authorizing regulators to obtain information and evidence from a variety of sources, including the following:

Information and documents in the files of the requested authority;

Information and documents regarding the matters set forth in the request for assistance.

Upon request, the requested authority can require production from any person designated in the request or any person who may possess the requested information or documents. The types of information and documents subject to required production include:

- Contemporaneous records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to these transactions;
- Records that identify: the beneficial owner and the person making the investment decision, and for each transaction, the account holder; the amount purchased or sold; the time of the transaction; the price of the transaction; and the individual and the bank or broker and brokerage house that handled the transaction;
- Information identifying persons who beneficially own or control non-natural persons organized in the jurisdiction of the requested authority.

Compelled, sworn testimony (where permissible) or the statement of a person regarding the matters set forth in the request for assistance. Where permissible under the laws of the jurisdiction of the requested authority, a representative of the requesting authority may be present at the taking of statements and may provide specific questions to be asked of any witness.

See, e.g., "Memorandum of Understanding Signed by SEC, CFTC, Bank of England and the Financial Services Authority," (Oct. 27, 1997).

The MOU also provides that each authority will make all reasonable efforts to provide unsolicited assistance to the other authorities in the form of information that it considers likely to be helpful to the other authorities in securing compliance with the laws and regulation applicable in their jurisdictions.

B. A Firm That is Subject to Regulation in Multiple Jurisdictions may Face Conflicting Demands From Regulators.

Records that are “secret” in “Jurisdiction A” may be “required” in “Jurisdiction B”.¹⁰ If a firm is doing business in both jurisdictions, it must anticipate and address the potential conflict.

International organizations have begun to direct efforts at reducing such conflicts, but also are taking care not to infringe on national regulatory prerogatives. The IOSCO Internet Report, for example, recognizes that market participants will benefit from consistent regulatory regimes that are applicable to Internet securities activities. Accordingly, it urges regulators to work together to develop principled approaches to reducing the potential for regulatory conflicts so that market participants can understand, in advance, the regulatory requirements to which their activities will be subject. At the same time, the IOSCO Report specifies that any approach should acknowledge that each regulator may retain the discretion to exercise regulatory authority and impose its own regulations on activities that have an impact on market participants and markets inside that regulator’s jurisdiction.

C. Privacy Issues

A particular jurisdiction’s procedures for conducting transactions and preserving personal information may differ from U.S. standards. Customers’ privacy expectations are governed by contract and law in the particular jurisdiction; the firm needs to assure that personnel coordinating production of records and documents effectively balance, within the limits of applicable law, regulators’ and customers’ expectations for compliance with subpoenas. Recognizing that there are differences in approach and different demands by regulators which may conflict with these legal requirements, firms may be best served by obtaining their customers’ agreement, up-front, to the firm’s compliance with foreign information/records requests. Such a blanket waiver, however, still must be evaluated in the context of the particular jurisdictions’ privacy and data protection laws.

VII. CONCLUSION.

Whether as the result of regulatory convergence or national vigilance, regulatory standards, requirements and enforcement are rising around the world. Indeed, even where the standards differ, the commitment for regulators to assist one another has become stronger. At the same time, as investors broaden their focus, the possibilities for business to expand on a cross border basis have never been greater. The coincidence of these events signals the need for financial firms to redouble their efforts to set a “tone of compliance” throughout their international organizations, to develop robust internal controls that monitor the business as it evolves, to change to accommodate emerging issues, and to establish

The firm’s dilemma may evoke the level of (or lack of) sympathy demonstrated by the U.S. Court of Appeals in *In re Grand Jury Proceedings, U.S. v. The Bank of Nova Scotia*, 740 F.2d 87 (11th Cir. 1984), *cert. denied*, 469 U.S. 1106 (1985). The court upheld a finding of civil contempt against The Bank of Nova Scotia because the bank had produced documents located in the Bahamas and Cayman Islands to a grand jury piecemeal and after substantial delay. The bank contended that it should not have been sanctioned with respect to the Cayman documents, because compliance with the subpoena would have required it to violate that jurisdiction’s bank secrecy laws. The court of appeals expressly rejected the argument that the bank suffered hardship due to the conflicting demands of the United States and the Cayman Islands, observing that the bank had chosen to do business in two jurisdictions with inconsistent laws, and therefore had the obligation to choose how to meet conflicting demands.

working relationships with regulators that ensure constructive dialogue can occur to facilitate resolution of any issues that may be identified. Finally, with the raised standards and improved enforcement efforts by regulators in the EU and Asia, it is no longer enough for the global firm to simply coordinate with the U.S., the firm must operate in a coordinated manner with national regulators across multiple jurisdictions.