Deutsche Bank

July 19, 2004

By E-Mail to
regs.comments@occ.treas.gov
and U.S. Mail

Office of the Comptroller of the Currency
250 E Street, SW
Public Reference Room
Mail Stop 1-5
Washington, DC 20219
Attention: Docket No. 04-12

By E-Mail to
regs.comments@federalreserve.gov
and U.S. Mail

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Docket No. OP-1189

By E-Mail to comments@fdic.gov
and U.S. Mail

Mr. Robert E. Feldman
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Federal Deposit Insurance Corporation
550 17th Street, NW
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Attention: Comments/OES

By E-Mail to rule-comments@sec.gov
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Jonathan G. Katz
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Securities and Exchange Commission
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Washington, DC 20549-0609
Attention: File No. S7-22-04

Ladies and Gentlemen:

Deutsche Bank AG appreciates this opportunity to comment on the Proposed Interagency Statement on Sound Practices Regarding Complex Structured Finance Activities, 69 Fed. Reg. 28980 (May 19, 2004) (the "Proposed Guidelines"). Deutsche Bank recognizes the importance of evaluating and controlling reputational, legal and other risks associated with structured finance transactions, and has already established a range of policies and procedures designed to identify, scrutinize and manage such risks at its businesses globally. While Deutsche Bank generally supports the comments submitted by industry trade associations, in particular those submitted on behalf of the Bond Market Association, the International Swaps and Derivatives Association and the Securities Industry Association, and by The Clearing House Association, it believes that a

separate comment is warranted in light of its own experience and the importance of the Proposed Guidelines.

Deutsche Bank shares the agencies' view that complex structured financial transactions ("CSFTs") are an essential part of U.S. and international capital markets and serve legitimate needs of financial institutions' clients. We endorse the general purpose of the Proposed Guidelines – to encourage regulated financial institutions to minimize potential legal and reputational risks when entering into a CSFT. Although it appears that the general approach of the Proposed Guidelines is to provide each institution with necessary flexibility to manage the risks associated with CSFTs within the context of its existing management procedures, controls and systems, Deutsche Bank believes that the Guidelines must more clearly reflect this principle.

Deutsche Bank believes that the Proposed Guidelines could serve as a valuable tool for financial institutions as they seek to continually improve their internal procedures, controls and systems to minimize potential risk, if the clarifications and modifications suggested herein and in the other comment letters referred to above are adopted. Deutsche Bank's suggestions, if adopted, would: (1) express that the Proposed Guidelines are intended only to provide financial institutions with a resource to assist them in minimizing legal and reputational risks, and not to create additional duties to other parties; (2) clarify when the Proposed Guidelines are addressing procedures applicable to CSFTs generally, as opposed to CSFTs presenting heightened levels of risk (which will be referred to hereinafter as "Heightened Risk Complex Structured Finance Transactions", or "HRCSFTs"); (3) more clearly reflect the principle that the Guidelines would preserve the flexibility for financial institutions to design their own procedures for controlling risks attendant to CSFTs; and (4) clarify that a financial institution should be responsible for ascertaining the client's intended accounting treatment and/or disclosures **only** where the institution has actual knowledge of facts that would reasonably cause it to believe that the customer intends to file materially misleading financial statements, or where the institution has custom-designed a HRCSFT to address the financial reporting or complex tax objectives of the customer, and not for any other CSFT. In addition, it is critical that the agencies consistently interpret the Guidelines, not only to eliminate variances between the agencies, but also to ensure that the agencies' supervisory and examination personnel understand that the Guidelines are exactly that – and not a prescriptive "checklist".

1. <u>No Duties to Other Persons</u>

It is clear that the agencies were motivated to issue the Proposed Guidelines as a result of financial institutions having recently incurred liability in civil and administrative actions arising out of abusive transactions by certain companies in which the institutions participated. 69 Fed. Reg. at 28981-982.

To the extent that they encourage financial institutions to continue to improve their policies and procedures to manage the legal and reputational risks associated with CSFTs, the Proposed Guidelines have the potential to assist financial institutions in

minimizing those risks. On the other hand, if courts and administrative tribunals are left free to interpret the Guidelines as creating new duties to other persons, the Guidelines are more likely to exacerbate institutions' legal and reputational risks than to minimize them, for reasons set forth below. It is unnecessary and undesirable for the Guidelines to even potentially be seen as creating such duties to other parties. The creation of such duties would discourage structured finance activity that the regulators have recognized as being not only legitimate, but also beneficial. The purpose of the Proposed Guidelines will be fulfilled if institutions design their CSFTs in such a way as to minimize, to the extent possible, attendant legal and reputational risks and refrain from participating in transactions that present unacceptable levels of risk.

Unfortunately, aspects of the Proposed Guidelines would, if adopted, actually tend to increase rather than decrease institutions' risk by imposing unprecedented and unnecessary duties to third parties in the following manner.

a. New Duties to Clients and/or Their Stakeholders

The Proposed Guidelines direct financial institutions to "ensure that the customer understands the risk and return profile of the transaction." Id. at 28987 (Reputational and Legal Risk). An institution can only give full and fair disclosure of the risks and return profile of a transaction; it cannot ensure that the customer understands the disclosure. If anyone has that duty, it is the customer's advisors, and it is inappropriate to require the institution to do more than provide the information necessary for a reasonable customer to understand the transaction. This concept is better described later in that same section of the Guidelines as follows: "Ensure that the institution provides the customer with appropriate information concerning the structure and risks of the transaction . . . ." Id. at 28987, 28988. By implicitly requiring the institution to act as adviser to the customer, the Guidelines would impose duties on the institution that it would not ordinarily accept as part of a financing transaction, and thereby create potential liability to the customer or its shareholders or successors in interest.

Of course, it is likely to be in an institution's best interests that its customer understands the structure and risks of the transaction. This concept was better expressed, however, in *The Principles and Practices for Wholesale Financial Market Transactions* (1995) (the *"Principles and Practices"*, available at www.newyorkfed.org/fxc/fx18.html) developed under the coordination of the Federal Reserve Bank of New York with the participation of the Reserve Bank and various industry trade groups. Section 5 of the *Principles and Practices* relates to relationships between participants to wholesale transactions in the over-the-counter financial markets. Subsection 5.2 states that: "A Participant **may wish to** evaluate . . . its counterparty's capability . . . to understand and make independent decisions about the terms and conditions of its Transactions" and **"may wish to** maintain policies and procedures for identifying . . . and addressing exceptional situations" where its counterparty cannot understand the transaction, takes risks disproportionate to potential benefits, or incorrectly assumes it can rely on the institution for advice (emphasis added). Section 5.3 contains additional steps that an institution "may wish to" adopt to protect itself from the consequences of a participant's

failure to understand a transaction. The "may wish to" formulation is superior to the prescriptive language used in the Guidelines, in that no legal duty is created.

The *Principles and Practices*, as stated in Section 1.2 therein, "articulate a set of best practices that Participants should aspire to achieve in connection with their Transactions. . . . The Principles do not create any legally enforceable obligations, duties, rights or liabilities." The Guidelines should contain similar language, and, in particular, should specifically disclaim the creation of any legally enforceable obligations, duties, rights or liabilities.

b. Loan Syndications

The Proposed Guidelines could have unanticipated adverse effects on the loan syndication market by implicitly imposing on agent banks new duties to syndicate members. Under current law, agent banks generally are not liable to syndicate members; such members are responsible for their own diligence in determining whether or not to extend credit to the customer.

It would be impractical, however, for a large number of syndicate members to fulfill all of the diligence and documentation requirements specified in the Proposed Guidelines. They would have limited or no direct access to the customer, and no borrower would want to submit itself to the intensive scrutiny anticipated in the Proposed Guidelines from a multitude of syndicate members. Exacerbating this problem is the probability that some members may have internal policies that define a pending transaction as "complex", while the lead bank does not.

Simply saying that each syndicate member must satisfy itself about the acceptability of legal and reputational risks inherent in each syndicated transaction, would impose duties on syndicate members that they cannot practically fulfill or increase duties of agent banks to syndicate members that they would be unlikely to accept without dramatic changes to the pricing of syndicated loans, to the detriment of customers with legitimate needs for syndicated structured finance transactions. The agencies should take care not to disrupt the existing syndication market, which provides an invaluable source of funding to the U.S. markets

2. Distinguish More Clearly Elements Applicable Only to HRCSFTs.

The Proposed Guidelines envision the adoption by financial institutions of processes to define CSFTs, identify HRCSFTs, and ensuring that HRCSFTs receive "an elevated and thorough review." Id. at 28983. Deutsche Bank believes that many elements of the Proposed Guidelines appear controversial only because they may be misinterpreted as applying to CSFTs in general rather than, as intended, to only HRCSFTs. As we understand the Guidelines, the only specific procedure that must apply to all CSFTs – apart from controls that would apply to all transactions of the institution, such as the existence of policies and procedures describing the responsibilities of various functions within the institution – is that all CSFTs must be reviewed on a consistent basis

by the institution's legal department. Id. at 28987. Assuming that this review is intended to refer to an approval process and not to a mandated review by internal lawyers of each document (a task which is frequently delegated to outside counsel, under internal counsel's supervision), this does not impose any significant incremental burden, as all such transactions that an institution would define for itself as being complex, even if not currently labeled explicitly as CSFTs, presumably already receive such review. Other mandated processes that seem incremental to those generally contained in institutions' existing policies and procedures are generally qualified by the modifier "appropriate", even if not qualified by the explicit phrase "transactions that may pose higher levels of legal and reputational risk" or similar language.

For example, review by control groups other than Legal is required only as "appropriate". Id. at 28986-987. The agencies also note that the goal of senior-level risk control committees established by some institutions "is to ensure that those [CSFTs] that may expose the financial institution to higher levels of financial, legal and reputational risk are comprehensively and consistently managed and controlled . . ." – not all CSFTs. Id. at 28986. The Proposed Guidelines acknowledge that it is appropriate that only the "most complicated or controversial [CSFTs]" are generally submitted to such a committee for approval.

Nevertheless, some passages in the Proposed Guidelines blur the distinction between processes applicable to all CSFTs as opposed to HRCSFTs. For example, the introduction of the 12 red flag events cited as possible indicators of a need for heightened scrutiny blurs the distinction between HRCSFTs and other CSFTs. The paragraph introducing the "red flags" begins: "Careful evaluations of the consequences of a transaction are particularly important when the transaction is designed to achieve a customer's financial reporting or complex tax objectives. Policies should clearly define the types of circumstances where the approval of transactions or patterns of transactions should be elevated to higher levels of financial institution management for reasons specific to legal or reputational risk." Id. at 28987-988. This language appropriately suggests that most HRCSFTs would involve transactions custom-designed for customers.

We believe that, with rare exception, it would take the presence of one or more red flag events, in conjunction with a transaction custom-designed to meet a customer's financial reporting or tax objectives, to present the elevated risks sufficient to transform a CSFT to a HRCSFT. That sensible interpretation is muddied, however, by the inclusion of a separate red flag event for "transactions that raise concerns about how the client will report or disclose the transaction . . . ." We suggest taking this latter sentence out of the list of red flags and either omitting it or including it in the paragraph preceding the list of red flags to indicate that this is a predicate condition that would usually need to be present before the existence of another red flag would cause a transaction to be viewed as a HRCSFT.

The paragraph immediately following the 12 "red flag" events reads: "Having developed a process to identify transactions that may pose higher levels of legal and reputational risk, financial institutions should implement procedures to address **these**

risks. These procedures should include, among other things: . . ." Id. at 28988 (emphasis added). The phrase "these risks" appears to relate to the higher levels of legal and reputational risk, but the eight bullet points that follow seem to apply to all CSFTs, not just HRCSFTs.

Finally, the Proposed Guidelines suggest that "financial institutions should maintain comprehensive documentation for all transactions approved, as well as disapproved transactions with controversial elements . . . ." No distinction is made between CSFTs and HRCSFTs, except as noted elsewhere that retention of documents related to CSFTs should aim at "minimizing legal and credit risks, as well as reducing unwarranted exposures to the financial institution's reputation." Id. at 28989. It is difficult to imagine how a rejected transaction poses any risks to an institution, so the purpose of the documentation standards is blurred. The "appropriate" modifier is auspiciously missing from the processes specified in the Documentation Standards section. Deutsche Bank believes that such a modifier should be inserted to reinforce the clear intent that the institution should maintain only such documentation as is necessary to minimize its legal, credit and reputational risks.

3. <u>Preserve Flexibility for Institutions to Design Their Own Appropriate Procedures and Controls</u>

In the Summary section of the Proposed Guidelines, the agencies assert that the purposes of the proposal are to ensure that financial institutions have effective policies and procedures in place to identify HRCSFTs, to ensure that HRCSFTs receive enhanced scrutiny by the institution, and to ensure that the institution does not participate in illegal or inappropriate transactions. Similarly, in the Supplemental Information, the agencies state that "it is critical that financial institutions have effective risk management and internal controls to ensure that the institutions' activities comply with the law and that all of the risks associated with a transaction – including legal and reputational risks – are identified and appropriately addressed." Id. at 28982. These purposes are embedded in the Statement itself. Id. at 28985. Moreover, part III of the proposal is titled: "Guidelines for Incorporating Structured Finance Transactions **Into Existing** Management Procedures, Controls and Systems" (emphasis added).

Deutsche Bank applauds the agencies for permitting each institution to adopt its own definition of CSFT, rather than imposing a one-size-fits-all definition that would capture transactions not deemed complex at the largest or more sophisticated institutions and potentially excluding transactions deemed complex at smaller or less sophisticated institutions. Id. at 28986 (Policies and Procedures). We also believe that the agencies were astute in recognizing that each institution must establish its own procedures to ensure appropriate escalation of HRCSFTs, and adopt its own documentation standards sufficient to minimize legal and reputational risks, without mandating specific procedures. Id. at 28987, 28989.

The foregoing demonstrates that the agencies generally recognize that a financial institution can successfully manage the legal and reputational risks pertaining to CSFTs

only if it has the flexibility to do so within the context of its existing procedures, controls and systems. Unfortunately, in providing factors for institutions to consider in defining CSFTs and establishing escalation procedures and documentation standards, the language of the Proposed Guidelines is sufficiently vague that examiners or plaintiffs in civil litigation could mistakenly interpret these factors as a checklist that must be included verbatim in each institution's policies and procedures.

The Proposed Guidelines list four factors for institutions to consider in defining a CSFT. Id. at 28985 (Definition and Key Risks of Complex Structured Finance Transactions). The Proposed Guidelines do not mandate that the presence of any one or more of these specified factors must require a transaction to be designated a CSFT. Institutions have varying levels of sophistication and experience, and a transaction that may be deemed "complex" by a retail-oriented institution may not be regarded as complex by an institution more accustomed to structuring commercial transactions. The use of SPEs in connection with asset securitizations may be routine for an institution active in securitization transactions, but constitute a CSFT with escalated risks for an institution that is just commencing securitization activities. The Proposed Guidelines should be clear that these four elements are merely factors to be considered in creating a definition of CSFT, rather than a checklist.

Similarly, Deutsche Bank is satisfied that the agencies recognize that the mere presence in a proposed transaction of one or more of the 12 "red flags" listed (id. at 28988) as indicating the possible existence of elevated risks does not automatically mean that the transaction must be subject to the institution's processes for HRCSFTs. Depending on the level of experience and sophistication of the institution and the personnel assigned to the normal transaction approval process, the presence of some of those red flag items may not necessarily require escalation. In fact, Deutsche Bank believes that none of the red flag events, by itself, would necessarily transform a CSFT to a HRCSFT without the presence of certain prerequisite conditions. See discussion at Part 2 of this letter, *supra*. In any case, the Proposed Guidelines clarify that the red flags are intended as guidance, not as a checklist.

Finally, Deutsche Bank believes that the Proposed Guidelines are intended to make it clear that the primary purpose of an institution's documentation standards should be to minimize legal and reputational risks. It would be helpful, however, for the Proposed Guidelines to specifically articulate that the forms of documentation listed in the section on Documentation Standards (id. at 28989) are suggestions, subject to the qualification that the purpose of documentation is to minimize legal and reputational risk, and, to a lesser but significant extent, to facilitate the ability of auditors and examiners to be able to efficiently review and understand a transaction. It cannot be consistent with the purposes of the Guidelines to require institutions to maintain documentation that would be irrelevant, immaterial, redundant, confusing, or more likely to exacerbate than to minimize legal and reputational risks.

4. Limit the Situations in Which Institutions Are Expected to Verify Clients' Accounting Treatments and Disclosures.

The Proposed Guidelines are somewhat unclear regarding one controversial element – namely, when it is appropriate for financial institutions to verify the accounting treatment and/or disclosures to be adopted by the customer. As we understand the section on Accounting and Disclosure by Customers, there are only three instances in which the Proposed Guidelines anticipate that the financial institution must scrutinize the customer's proposed accounting treatment and disclosures: (1) in the case of a "transaction designed primarily to achieve financial reporting or complex tax objectives"; (2) when the institution has reason to believe that the customer intends to file "materially misleading financial statements"; and (3) "to address the creation, acquisition, and use of institution and client-sponsored SPEs." Id. at 28988-989.

By limiting the circumstances in which an institution would be expected to insist upon receiving information about a customer's anticipated accounting treatment or financial disclosures, the agencies appropriately recognize that there are routine CSFTs that do not present elevated risks, which can be processed through a transaction approval process that is less intensive than the processes to be used for HRCSFTs. In such cases, it is unlikely that the client would have any expectation that its accounting or disclosures would be other than in accordance with its normal practice for similar transactions.

However, the Proposed Guidelines appear to require scrutiny of customers' intentions regarding financial and tax reporting even in some circumstances that do not appear to present sufficiently elevated risks. Clients would be unlikely to be willing to respond in detail about their anticipated disclosures in connection with every CSFT, much less make their attorneys or accountants available to the financial institution, almost always for legitimate reasons -- such as protection of privilege or proprietary information; to prevent delay in effecting the transaction that might obviate the benefits of the transaction; or because the client's accountants refuse to incur incremental legal risk by providing an accounting opinion to a third party.

In keeping with the express purposes of the Proposed Guidelines, as reiterated above, the agencies should be satisfied if a financial institution has sufficient procedures and controls to identify and control risks associated with CSFTs. The regulators should not seek to substitute their judgment for that of an institution's legal, accounting and other professional experts by mandating specific procedures that may inadvertently exacerbate risk, instead of mitigating it. By creating an absolute obligation for a financial institution to abandon a proposed transaction because of a client's refusal or inability to make its accountants available, the agencies put institutions at risk of losing profitable, legitimate transactions with no commensurate risk-reduction benefit. Therefore, the Proposed Guidelines should impose this obligation only where necessary to protect the institution from legal and reputational risks. The agencies should not put financial institutions in the position of routinely assuming responsibility for their clients' accounting and disclosure decisions or of substituting for the clients' outside accounting

and legal professionals. Such an expectation would exacerbate, not minimize, the legal and reputational risks attendant in financial institutions' CSFTs.

Consistent with these principles, this section of the Proposed Guidelines could be improved by making three changes. The first would be to revise the second sentence by adding the words in bold type below, so that it would read: "For transactions identified as involving **such** elevated risks, the financial institution's procedures should ensure that staff approving the transactions **seek to** obtain and document complete and accurate information about the customer's proposed accounting treatment of the transaction, financial disclosures relating to the transaction, as well as the customer's objectives for entering into the transaction." This would clarify that these requirements apply only for "transactions designed primarily to achieve financial reporting or complex tax objectives" – the only circumstance in which the institution would clearly be entitled to receive such information from its customer, and would make it clear that a financial institution retains the discretion to accept a customer's explanation of why it is unwilling to share certain requested information.

The second change would be to make it clear that the institution would be expected to verify the customer's plans regarding financial reporting where the institution has actual knowledge of facts that would reasonably cause it to believe that the customer may file materially misleading financial statements, and not merely because the opportunity for such conduct exists. An institution possessing such knowledge would be justified in getting a satisfactory response from the customer before proceeding with a transaction, even if the transaction were not designed to meet the customer's financial and tax reporting objectives.

The third change would be to eliminate the last paragraph in the section relating to SPEs, or to clarify that the accounting, legal and tax issues to be evaluated by the institution's risk control groups are those issues pertaining to the institution itself, and not to the customer. There is no reason to subject the customer to intrusive questioning merely because a transaction utilizes a SPE, unless the transaction was custom-designed to achieve the customer's financial reporting or tax objectives, or unless the institution has actual knowledge of facts that reasonably lead it to believe the customer will file materially misleading financial statements.

As an aside, we note that the Background Section to the Supplementary Information refers to CSFTs that the agencies view as problematic because they were used to alter a customer's public financial statements "in ways that are not consistent with the economic reality of the transactions . . . ." Id. at 28981. While not part of the Proposed Guidelines, this language should be excised when the final version of the Guidelines is published. We do not dispute that it is important for the financial institution to understand the economic substance of a transaction and to refrain from entering into transactions where it is apparent that the customer has an improper intent with respect to financial or tax reporting. However, the test for financial reporting is not "economic reality"; rather, the standard is whether the transaction is accounted for in accordance

with applicable accounting standards, consistently applied. See id. at 28988, text accompanying n.7.

5. The Agencies Must Ensure Consistency in Interpreting the Guidelines.

As noted above, the Proposed Guidelines leave financial institutions with the flexibility to define CSFTs, specify the levels of risk that require escalation within the institution's managerial hierarchy, and determine the appropriate internal procedures and controls, including documentation standards, to be applied to CSFTs generally and to HRCSFTs. The agencies have wisely provided factors to be considered by financial institutions in exercising this flexibility without mandating the use of the factors as a checklist. This flexibility creates the possibility for varying interpretations of the Proposed Guidelines between different agencies, different geographic offices within the same agency, and different examiners within the same office of an agency. It is imperative, therefore, that the agencies make the clarifications suggested above to eliminate, to the extent possible, the potential for significant differences of interpretation. This is particularly true for financial organizations, such as Deutsche Bank, that manage subsidiaries subject to regulation and supervision by two or more of the issuing agencies pursuant to common policies and procedures. It would be untenable for large financial organizations to be subject to varying interpretations of the Guidelines by different agencies, or different offices of the same agency, supervising different operating entities.

In addition to making these clarifications, it will be important that examiners from the various agencies be trained in a uniform manner as to the application of the Guidelines in order to ensure consistent application of the Guidelines to all financial institutions and to different subsidiaries or offices of the same financial organization.

We hope that you find these comments helpful as you finalize the Guidelines. We believe that adoption of the modifications suggested above would facilitate the fulfillment of the underlying purpose of the Proposed Guidelines – to forge a partnership between the agencies and their regulated institutions to improve the practices of the industry so as to minimize legal and reputational risks and thereby maintain the strength and integrity of the industry and each of its member institutions. We thank you for your consideration.

Very truly yours,

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