

Summary of the November 1, 2004 Meeting Regarding the Proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities

On November 1, 2004, representatives and members of the Bond Market Association, the International Swaps and Derivatives Association, Inc. and the Securities Industry Association (the "Associations") met with staff of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Securities and Exchange Commission at the Associations' request to discuss the proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities ("Proposed Statement"). (A list of attendees is below.) At the meeting industry representatives submitted a redlined version of the Proposed Statement reflecting the changes that the Associations' representatives believe should be made to the Proposed Statement to address the concerns raised by commenters. A copy is attached. At the meeting the Associations' representatives and staff of the Agencies discussed the changes to the Proposed Statement recommended by the Associations.

ATTENDEES	AFFILIATION
Marjorie Gross	The Bond Market Association
Kimberly Summe	International Swaps & Derivatives Association
Mary Ann Gadziala	SEC
Lori Richards	SEC
Richard Spillenkothen	FRB
Michael Martinson	FRB
Kieran Fallon	FRB
Jerry Quinn	Securities Industry Association
Ed Rosen	Cleary Gottlieb
Kathy Dick	OCC
Anne Zorc	FRB
Donald Lamson	OCC
Ellen Broadman	OCC
Linda Sundberg	SEC
Annette L. Nazareth	SEC
Randall Roye	SEC
Virginia Gibbs	FRB
Greg Feldberg	FRB
Sabeth Siddique	FRB

COLOR CODE

Red	Text that captures an overly broad scope of transactions
Green	Text that is overly prescriptive
Pink	Text that raises an international jurisdiction/competitive parity problem
Orange	Text that is problematical for one reason or another, frequently inconsistencies
Violet	Text that is particularly good
<u>Black</u>	Proposed new text
Grey	Deleted text (usually because text potentially creates liability directly or indirectly, by imposing an inappropriate gatekeeper function or by imposing an ambiguous or unachievable standard).

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. 04-12]

Office of Thrift Supervision [No. 2004-27]

FEDERAL RESERVE SYSTEM

[Docket No. OP-1189]

FEDERAL DEPOSIT INSURANCE CORPORATION

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49695; File No. S7-22-04]

Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Office of Thrift Supervision, Treasury (OTS); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Securities and Exchange Commission (SEC).

ACTION: Notice of interagency statement with request for public comment.

SUMMARY: The OCC, OTS, Board, FDIC, and SEC (collectively, the Agencies) are requesting public comment on a proposed interagency statement concerning the complex structured finance activities of financial institutions (national and state banks; bank holding companies; federal and state savings associations; savings and loan holding companies; and SEC registered broker-dealers and investment advisors) supervised by the Agencies. As recent events have highlighted, a financial institution may assume substantial reputational and legal risk if the institution enters into a complex structured finance transaction with a customer and the customer uses the transaction to circumvent regulatory or financial reporting requirements, evade tax liabilities, or further other illegal or improper behavior in violation of applicable law or other obligations. The proposed interagency statement (Statement) describes the types of internal controls and risk management procedures that the Agencies believe are particularly effective in assisting financial institutions to identify and

address the reputational, legal, and other risks associated with complex structured finance transactions. The Statement, among other things, provides that financial institutions should have effective policies and procedures in place to identify those complex structured finance transactions that may involve heightened reputational and legal risk, to ensure that subject these transactions receive enhanced scrutiny by the institution, and to ensure that protect the institution does not participate in illegal or inappropriate from participating in transactions that present unacceptable legal or reputational risk.

DATES: Comments regarding the Statement should be received on or before June 18, 2004. Comments regarding the information collections contained in the Statement should be received on or before July 19, 2004.

ADDRESSES:

OCC: You may submit comments, identified by Docket number 04-12 by any of the following methods:

E-mail address: <http://www.regs.comments@occ.treas.gov>.
Fax: (202) 874-4448.

Mail: Office of the Comptroller of the Currency, 250 E Street, SW., Public Reference Room, Mail Stop 1-5, Washington, DC 20219.

Hand Delivery/Courier: 250 E Street, SW., Attn: Public Reference Room, Mail Stop 1-5, Washington, DC 20219. You may review the comments received by the OCC and other related materials by any of the following methods:

Viewing Comments Personally: You may personally inspect and photocopy comments received at the OCC's Public Reference Room, 250 E Street, SW., Washington, DC. You can make an appointment to inspect comments by calling (202) 874-5043.

Viewing Comments Electronically: You may request copies of comments received for a particular docket via email or CD-ROM by contacting the OCC's Public Reference Room at <http://www.foia-pa@occ.treas.gov>.

OTS: You may submit comments, identified by No. 2004-27, by any of the following methods:

• **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

• **E-mail:** regs.comments@ots.treas.gov. Please include No. 2004-27 in the subject line of

the message, and include your name and telephone number in the message.

• **Fax:** (202) 906-6518.

• **Mail:** Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: No. 2004-27.

• **Hand Delivery/Courier:** Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office, Attention: No. 2004-27.

Instructions: All submissions received must include the agency name and document number. All comments received will be posted without change to <http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1>, including any personal information provided.

Docket: For access to the docket to read background documents or comments received, go to <http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1>. In addition, you may inspect comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-7755. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10 a.m. and 4 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

Board: You may submit comments, identified by Docket No. OP-1189, by any of the following methods:

• **Board's Web Site:** <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

• **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

• **E-mail:** regs.comments@federalreserve.gov. Include docket number in the subject line of the message.

• **Fax:** (202) 452-3819 or (202) 452-3102.

• **Mail:** Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, except as necessary for technical reasons.

Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments also may be viewed electronically or in paper form in Room MP-500 of the Board's Martin Building (C and 20th Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

FDIC: Written comments should be addressed to Robert E. Feldman, Executive Secretary, Attention: Comments/OES, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429. Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7:00 a.m. and 5:00 p.m. (Fax number: (202) 898-3838; Internet address: comments@fdic.gov). Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, NW., Washington, DC, between 9 a.m. and 4:30 p.m. on business days.

SEC: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/policy>); or
- Send an e-mail to rulecomments@sec.gov. Please include File Number S7-22-04 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File Number S7-22-04. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/policy>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying

information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT:

OCC: Kathryn E. Dick, Deputy Comptroller, (202) 874-4660, Risk Evaluation, Grace E. Dailey, Deputy Comptroller, (202) 874-4610, Large Bank Supervision, Ellen Broadman, Director, (202) 874-5210, Securities and Corporate Practices Division, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

OTS: John C. Price, Jr., Director, Supervision Policy, Examinations and Supervision Policy, (202) 906-5745; Debbie Merkle, Project Manager, Credit Risk, Supervision Policy, (202) 906-5688; David A. Permut, Senior Attorney, Business Transactions Division, (202) 906-7505, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

Board: Michael G. Martinson, Senior Adviser (202-452-3640), Walt H. Miles, Assistant Director (202) 452-5264, or Sabeth I. Siddique, Manager (202) 452-3861, Division of Banking Supervision and Regulation; or Kieran J. Fallon, Managing Senior Counsel (202) 452-5270, Legal Division, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Users of Telecommunication Device for Deaf (TTD) only, call (202) 263-4869.

FDIC: William A. Stark, Associate Director, Capital Markets Branch, (202) 898-6972, Jason C. Cave, Chief, Policy Section, Capital Markets Branch, (202) 898-3548, Division of Supervision and Consumer Protection; or Mark G. Flanigan, Counsel, Supervision and Legislation Branch, Legal Division, (202) 898-7426, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

SEC: Mary Ann Gadziala, Associate Director, or Juanita Bishop, Supervisory Accountant at (202) 942-7400, Office of Compliance Inspections and Examinations, or Catherine McGuire, Chief Counsel, Linda Stamp Sundberg, Attorney Fellow, or Randall W. Roy, Special Counsel, at (202) 942-0073, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-1001.

SUPPLEMENTARY INFORMATION:

I. Background

Financial markets have grown rapidly over the past decade and innovations in financial instruments have facilitated the structuring of cash flows and the allocation of risk among borrowers and investors in more efficient ways. This innovation has led to the development of a wide array of structured finance products, including financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, and specialized financial conduits that manage pools of purchased assets.

National and state banks, bank holding companies, and SEC-registered broker-dealers and investment advisers have played an active and important role in the development of structured finance products and markets. In this regard, financial institutions often play an important role in structuring, arranging or participating in complex structured finance transactions for their own use and to facilitate the needs of customers.

As financial intermediaries, financial institutions play a critical role in ensuring the integrity of financial markets and maintaining the trust and public confidence essential to the proper functioning of the capital markets. In the vast majority of cases, structured finance products and the role played by financial institutions with respect to these products have served the legitimate business purposes of customers. This has allowed structured finance products to become an essential part of U.S. and international capital markets.

The more complex variations of structured finance products, however, have placed pressure on the interpretations of accounting and tax rules, and, in turn, have given rise to significant concerns about the legality and appropriateness of certain individual transactions under applicable accounting or tax rules. Importantly, a limited number of complex structured finance transactions appear to have been used to alter the appearance of a customer's public financial statements in ways that are not consistent with the economic reality do not fairly present the impact of the transactions on the financial condition of the customer or to inappropriately reduce a customer's tax liabilities in a manner inconsistent with U.S. tax law. In the most extreme cases, structured finance transactions appear to have been used in fraudulent schemes to misrepresent the

financial condition of public companies or evade taxes.

Financial institutions must conduct their operations in compliance with applicable law and regulations, and institutions that do not may be subject to enforcement actions by the Agencies and lawsuits by private parties. As recent events have highlighted, financial institutions may face substantial legal¹ risk to the extent they participate perform a substantial role in complex structured finance transactions that are used by customers to circumvent regulatory or financial reporting requirements, evade tax liabilities, or further other illegal or improper behavior by the customer. These risks may also arise in the context of transactions used by management of a customer in a manner that violates management's obligations to shareholders. Involvement in such transactions also may damage an institution's reputation and franchise value. Reputational risk poses a major threat to financial institutions because the nature of their business requires maintaining the confidence of customers, creditors, and the general marketplace. Importantly, reputational risks may arise even where the transactions involved are structured to technically comply with existing laws and regulations.

The events associated with Enron Corp. demonstrate the potential for the abusive use of complex structured finance transactions, as well as the substantial legal and reputational risks that financial institutions face when they participate in complex structured finance transactions that are designed or used for improper illegal purposes. After conducting investigations, the OCC, Federal Reserve System, and the SEC took strong and coordinated civil and administrative enforcement actions against certain financial institutions that participated in complex structured finance transactions with Enron Corp. that appeared to have been designed or used to shield the company's true financial health from the public.^{1,2}

¹ References to legal risk in the Statement include the litigation risks that can arise, as a result of public perceptions of culpability, when a financial institution participates in a transaction that is used by a customer to accomplish an illegal purpose, whether or not the nature of the financial institution's participation in the transaction gives rise to actual legal liability.

² See Exchange Act Release No. 48230 (July 28, 2003), Written Agreement by and between Citibank, N.A. and the Office of the Comptroller of the Currency, No. 2003-77 (July 28, 2003) (pertaining to transactions entered into by Citibank, N.A. with Enron Corp.), and Written Agreement by and between Citigroup, Inc. and

These actions involved significant financial penalties on the institutions and required the institutions to take several measures to strengthen their risk management practices for complex structured finance activities. The structured finance relationships between some financial institutions and Enron Corp. also sparked an investigation by the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Governmental Affairs,³ as well as numerous lawsuits by private litigants.

The Agencies have long expected financial institutions to develop and maintain robust control infrastructures enabling them fully to identify, evaluate and control all dimensions of risk associated with their business activities. In the area of complex structured finance transactions, it is critical that financial institutions have effective risk management and internal controls to ensure that the that are reasonably designed to enable financial institutions' activities to comply with the applicable law and that all of the to identify, evaluate and address risks associated with a transaction—including legal and reputational risks—are identified and appropriately addressed.

In light of recent events, the OCC, Board, and SEC conducted special reviews of several banking and securities firms that are significant participants in the market for complex structured finance products. These reviews were designed to evaluate the product approval, transaction approval, and other internal controls and processes used by these institutions to identify and manage the legal, reputational, and other risks associated with complex structured finance transactions. These assessments indicated that many financial institutions have already taken meaningful steps to improve their control infrastructures relating to complex structured finance products in light of the control weaknesses evidenced by recent events. The Agencies also have focused attention on the complex structured finance

the Federal Reserve Bank of New York, dated July 28, 2003 (pertaining to transactions involving Citigroup Inc. and its subsidiaries and Enron Corp. and Dynegy Inc.); SEC Litigation Release No. 18252 (July 28, 2003) and Written Agreement by and among J.P. Morgan Chase & Co., the Federal Reserve Bank of New York, and the New York State Banking Department, dated July 28, 2003 (pertaining to transactions involving J.P. Morgan Chase & Co. and its subsidiaries and Enron Corp.).

³ See *Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions*, Report Prepared by the Permanent Subcommittee on Investigations, Comm. on Governmental Affairs, United States Senate, S. Rpt. 107-82 (2003).

activities of financial institutions in the normal course of our supervisory process.

II. Proposed Statement on Sound Practices Concerning the Complex Structured Finance Activities of Financial Institutions

In order to help ensure that assist financial institutions have in developing and maintain maintaining adequate control infrastructures for complex structured finance transactions, the Agencies have developed, and are seeking public comment on, the attached Statement included at the end of this notice.⁴ The Statement describes a number of internal controls and risk management procedures that the Agencies believe are particularly useful in assisting financial institutions to ensure that in conducting their complex structured financial activities are conducted in accordance with applicable law and that institutions effectively manage the full range of risks associated with these activities, including legal and reputational risks.

The Statement reflects the "lessons learned" from recent events, as well as what the Agencies believe to be sound practices in this area based on supervisory reviews and experience. Financial institutions should consider the Statement in developing and evaluating the institution's risk controls for complex structured finance activities. The following provides a brief overview of the key aspects of the Statement.

As a general matter, the Statement indicates that financial institutions offering complex structured finance transactions should document and maintain a comprehensive set of formal, firm-wide policies and procedures that provide for the identification, documentation, evaluation, and control of the full range of credit, market, operational, legal, and reputational risks that may be associated with these transactions. These policies and procedures should be reasonably designed to ensure that enable the financial institution to consistently and appropriately manages manage its complex structured finance activities on both a per transaction and relationship basis, with all corporate customers (including publicly and privately owned corporate entities—government entities and individuals) and in all

⁴ For institutions supervised by the Board, the OCC, the OTS, and the FDIC the statement will represent supervisory guidance. For institutions registered with the SEC, the statement will represent a policy statement.

jurisdictions where the financial institution operates.

The board of directors of a financial institution has ultimate responsibility for establishing the institution's risk tolerances for complex structured finance transactions and ensuring requiring that a sufficiently strong risk control framework is in place to guide the actions of the financial institution's personnel and requiring the implementation of mechanisms to enable management to monitor the efficacy of the institution's control framework. The board of directors and senior management also should send a strong message to others in the financial institution about the importance of integrity, compliance with the law, and overall good business ethics, which may be implemented through a Code of Professional Conduct.

- As described further in the Statement, an institution's policies and procedures should define what constitutes a complex structured finance transaction and should, among other things—

- Define the process that financial institution personnel must follow to obtain approval for complex structured finance transactions;

- Establish a control process for the approval of all new complex structured finance products;

- Ensure that the establish a control process for identifying, evaluating and managing the legal and reputational and legal risks associated with a complex structured finance transaction, or series of transactions, are identified and evaluated in both the transaction and new product approval process and appropriately managed by the institution;

- Ensure that financial institution staff appropriately reviews and documents the customer's proposed accounting treatment in the context of complex structured finance transactions, financial disclosures relating to the transactions, and business objectives for entering into the transactions that have been identified as appropriate for elevated review, establish a control process for addressing and documenting the resolution of any management concerns identified in the review process regarding the customer's proposed accounting, tax, regulatory, disclosure or other treatment of a transaction, or the adequacy of the customer's understanding of the transaction;

- Provide for the generation, collection and retention of appropriate documentation relating to all complex structured finance transactions;

- Ensure that Provide to senior management and the board of directors of the institution receive appropriate and timely management reports concerning the efficacy of the institution's control environment for complex structured finance activities;

- Provide for periodic independent reviews of the institution's complex structured finance activities to ensure verify that the institution's policies and controls are being implemented effectively and to identify potential compliance issues;

- Ensure Provide for effective internal audit coverage of the institution's complex structured finance activities; and

- Ensure that Provide appropriate training for financial institution personnel receive appropriate training concerning the institution's policies and procedures governing its complex structured finance activities.

An institution should establish a clear process for identifying those complex structured finance transactions that involve heightened legal and reputational risks. Once a transaction is identified as involving potentially heightened legal or reputational risk, the institution should ensure that these transactions receive an elevated and for a thorough review by an appropriate combination of independent control and senior personnel. If, after conducting this review, the financial institution determines that a proposed transaction may likely to result in the customer filing materially misleading financial statements, a violation of applicable law the financial institution should decline to participate in the transaction, or condition its participation upon the customer making express and accurate disclosures regarding the nature and financial impact of the transaction on the customer's financial condition, or take other steps to ensure that modification of the transaction or the customer taking appropriate steps to provide a reasonable assurance to the financial institution does not participate in an inappropriate transaction that no such violation will occur.

The Statement includes examples of characteristics that may indicate that a

transaction or series of transactions involves elevated levels of legal or reputational risk and that, thus, should be taken into account in determining whether the transaction or transactions should be subject to heightened review by the institution. The examples included in the Statement are not exclusive and institutions may differ in the sets of characteristics they use in identifying transactions that may involve heightened risks.

Institutions, however, should be conservative when exercise prudence in establishing these characteristics and the ultimate goals of all institutions should remain the same—to identify those transactions that require additional scrutiny at inception and to ensure that subject transactions receive a level of review that is commensurate with the legal and reputational risks associated with the transaction and the nature and scope of the institution's role in the transaction.

Because the Statement discusses sound practices related to complex structured finance activities—activities that typically are conducted only by larger financial institutions—the Statement would not be relevant and, therefore, would not apply to most small institutions. Moreover, an institution's policies and procedures concerning complex structured finance activities should be tailored to, and appropriate in light of, the institution's size and the nature, scope, and risk of its complex structured finance activities.

The Agencies request comment on all aspects of the Statement and will revise the Statement as appropriate after a review of public comments.

III. Paperwork Reduction Act

The Board, the FDIC, the OTS, and the OCC have determined that the Statement, which will represent supervisory guidance for institutions supervised by the Board, the FDIC, the OTS, and the OCC, contains collections of information for purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35). The OCC, the FDIC, the OTS, and Board request public comment on all aspects of the collections of information contained in the Statement. Also, the OCC, FDIC, OTS, and Board request comment on whether institutions involved in complex structured finance transactions currently are in compliance with the Statement and the information collections therein.

The OCC, FDIC, OTS, and Board also invite comment on:

(1) Whether the collections of information contained in the Statement are necessary for the proper performance of each agency's functions, including whether the information has practical utility;

(2) The accuracy of each agency's estimate of the burden of the proposed information collections;

(3) Ways to enhance the quality, utility, and clarity of the information to be collected;

(4) Ways to minimize the burden of the information collections on respondents, including the use of automated collection techniques or other forms of information technology; and

(5) Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information.

Respondents/record keepers are not required to respond to these collections of information unless the Board, the FDIC, the OTS, and OCC display a currently valid Office of Management and Budget (OMB) control number. The OCC, FDIC, and OTS currently are requesting approval of these information collections from OMB, and the Board is processing this collection under its delegated authority.

The OCC, FDIC, OTS, and Board estimates of the total annual burden of the collections of information contained in the Statement on the financial institutions they supervise follow.

OCC: The collection of information requirements contained in the Statement will be submitted to the OMB in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35). The OCC will use any comments received to evaluate the collections and verify its burden estimates. The OCC believes that only the largest national banks and U.S. branches of foreign banks are involved in these activities. Further, as a matter of usual and customary business practice and in light of recent events, involved institutions already have installed policies and procedures similar to those envisioned in the Statement. However, institutions will have to verify and update their policies and procedures periodically to ensure that they are adequate and current.

Comments on the collections of information should be sent to John Ference or Camille Dixon, Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 8-4, Attention: Docket Number 04-12 (1557-CSFA), Washington, DC 20219. You may also send comments by electronic mail to camille.dixon@occ.treas.gov. You should also send a copy of your comments to OMB

Desk Officer, Mark Menchik, Office of Information and Regulatory Affairs, Office of Management and Budget, Paperwork Reduction Project (1557-CSFA), Washington, DC 20503. Alternatively, you may e-mail your comments to mmenchik@omb.eop.gov, or fax them to (202) 395-6974.

The potential respondents are the largest national banks and U.S. branches of foreign banks.

Estimated number of respondents: 21.

Estimated average annual burden hours per respondent: [100 hours]

Estimated total annual burden: [2,100] burden hours.

FDIC: The collection of information requirements contained in the Statement will be submitted to the OMB in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35). The FDIC will use any comments received to evaluate the collections and verify its burden estimates. The FDIC believes that only the largest state nonmember banks are involved in these activities. Further, as a matter of usual and customary business practice and in light of recent events, involved institutions already have installed policies and procedures similar to those envisioned in the Statement. However, institutions will have to verify and update their policies and procedures periodically to ensure that they are adequate and current.

Comments on the collections of information should be sent to Thomas Nixon, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429. Comments may be hand-delivered to the guard station at the rear of the 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m. Comments should also be submitted to the OMB desk officer for the FDIC: Mark Menchik, Office of Information and Regulatory Affairs, Office of Management and Budget, New Executive Office Building, Washington, DC 20503. Alternatively, you may email your comments to mmenchik@omb.eop.gov, or fax them to (202) 395-6974.

The potential respondents are the largest state nonmember banks.

Estimated number of respondents: 5.

Estimated average annual burden hours per respondent: [100 hours]

Estimated total annual burden: [500] burden hours.

OTS: The collection of information requirements contained in the Statement will be submitted to OMB in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35). OTS will use any comments received to evaluate the collections and verify its burden estimates. The OTS assumes that only the largest savings associations and savings and loan holding companies could be involved in these activities. Further, as a matter of usual and customary business practice and in light of recent events, involved institutions already have installed policies and procedures similar to those envisioned in the Statement. However, institutions will have to verify and update their policies and procedures periodically to ensure that they are adequate and current.

Send comments, referring to the collection by title of the proposal, to Information Collection Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552; send a facsimile transmission to (202) 906-6518; or send an e-mail to infocollection.comments@ots.treas.gov. OTS will post comments and the related index on the OTS Internet Site at <http://www.ots.treas.gov>. In addition, interested persons may inspect comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment, call (202) 906-5922, send an e-mail to publicinfo@ots.treas.gov, or send a facsimile transmission to (202) 906-7755. You should also send a copy of your comments to OMB Desk Officer, Mark Menchik, Office of Information and Regulatory Affairs, Office of Management and Budget, Paperwork Reduction Project (1550-NEW), Washington, DC 20503. Alternatively, you may e-mail your comments to mmenchik@omb.eop.gov, or fax them to (202) 395-6974.

The potential respondents are the largest savings associations and savings and loan holding companies.

Estimated number of respondents: 5.

Estimated average annual burden hours per respondent: [100] hours.

Estimated total annual burden: [500] burden hours.

Board: In accordance with section 3506 of the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35; 5 CFR 1320, appendix A.1), the Board reviewed the Statement under the authority delegated to the Board by the OMB. The Board believes that only the

largest state member banks, bank holding companies, and U.S. branches and agencies of foreign banks are involved in complex structured finance activities. Further, as a matter of usual and customary business practice and in light of recent events, involved institutions already have adopted policies and procedures similar to those envisioned in the Statement. However, the institutions will have to verify and update their policies and procedures periodically to ensure that they are adequate and current.

Comments on the collections of information should be sent to Michelle Long, Acting Federal Reserve Board Clearance Officer, Division of Research and Statistics, Mail Stop 41, Board of Governors of the Federal Reserve System, Washington, DC 20551. You should also send a copy of your comments to OMB Desk Officer, Mark Menchik, Office of Information and Regulatory Affairs, Office of Management and Budget, Paperwork Reduction Project (1557—To Be Determined), Washington, DC 20503. Alternatively, you may e-mail your comments to mmenchik@omb.eop.gov, or fax them to (202) 395-6974.

The potential respondents are the largest state member banks, bank holding companies, and U.S. branches and agencies of foreign banks.

Estimated number of respondents: 20.

Estimated average annual burden hours per respondent: [100 hours.]

Estimated total annual burden: [2,000] hours.

The proposed Statement follows.

Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities

I. Introduction

Financial markets have grown rapidly over the past decade and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, specialized financial conduits that manage pools of purchased assets, along with other structured transactions have usually served the legitimate business purposes of the customers of financial institutions and are an essential part of U.S. and international capital markets.

Financial institutions have played an active and important role in the development of structured finance products and markets.

Structured finance transactions are often employed to manage risk or for other legitimate business purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. The more complex variations of selected structured finance transactions have, however, placed pressure on the interpretations of accounting and tax rules, and this has given rise to significant concerns about the risks associated with certain individual transactions. More so, a limited number of transactions appear to have been used primarily to alter the appearance of a customer's public financial statements in ways that are not consistent with the economic reality do not fairly present the impact of the transactions on the financial condition of the customer or to inappropriately reduce a customer's tax liabilities in a manner inconsistent with applicable tax law. In the most extreme cases, structured finance transactions appear to have been used in fraudulent schemes primarily to misrepresent the financial condition of public companies or evade taxes. Some financial institutions have been subject to criminal sanctions, and civil and administrative enforcement actions by the regulatory agencies, for participating in complex structured finance transactions used by a public company in reporting false or misleading financial statements.

Financial institutions are in a unique position given their role in structuring, arranging or participating in complex structured finance transactions for their own use and to facilitate the needs of their customers. When a financial institution provides advice on, arranges or actively participates performs a substantial role in a complex structured finance transaction, it assumes the usual market, credit, and operational risks and It also may assume assumes potentially substantial reputational and legal risk to the extent that an end-user enters into its customer uses the transaction for improper purposes unlawful purposes or otherwise in a manner inconsistent with the obligations of customer's management to shareholders. Considering the inherent complexity of many structured finance transactions and the many risks associated with these transactions, it is critical that financial institutions have effective risk management and internal controls relating to these products to ensure compliance in order to comply with the law and to effectively monitor and control the risks associated with these transactions. Financial

institutions may not engage in complex structured finance transactions in violation of the law and institutions that violate the law may be subject to enforcement action and civil or criminal penalties.

The regulatory agencies Agencies have long expected financial institutions to develop and maintain robust control infrastructures enabling them to fully identify, evaluate and control all dimensions of risk associated with their business activities. In the wake of recent developments, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the U.S. Securities and Exchange Commission are issuing this guidance to financial institutions that we supervise ("financial institutions" or "institutions")⁴ to describe a number the core elements of, and the principles that should guide a financial institution in developing, an effective system of internal controls and risk management procedures that we believe are useful to effectively to manage the risks associated with complex structured finance transactions.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this guidance draws heavily on controls and procedures that our agencies the Agencies previously have found to be effective in managing and controlling risks and identifies ways in which these controls and procedures can effectively be applied to the institution's complex structured finance activities. Financial institutions should consider this guidance in developing, or evaluating existing, risk controls for complex structured finance activities.

The Agencies note, however, that the specific controls and procedures described in this Statement are not the exclusive means available to financial institutions to manage the related risks. Financial

⁴ These institutions are national banks in the case of the Office of the Comptroller of the Currency; federal and state savings associations and savings and loan holding companies in the case of the Office of Thrift Supervision; state member banks and bank holding companies in the case of the Federal Reserve Board; state nonmember banks in the case of the Federal Deposit Insurance Corporation; and registered broker-dealers and investment advisers in the case of the Securities and Exchange Commission. The U.S. branches and agencies of foreign banks supervised by the Federal Reserve Board, the Office of the Comptroller, and the Federal Deposit Insurance Corporation also are considered to be financial institutions for purposes of this guidance.

institutions may implement alternative procedures and controls, based on their individual circumstances and control environments, that are reasonably designed to accomplish equivalent risk management or control objectives. These risk controls should supplement, or may be incorporated as an integral part of, the financial institution's more general internal controls and risk management systems, as appropriate.

The Agencies further note that this Statement is intended to provide guidance to financial institutions in formulating and implementing effective policies and procedures for complying with their responsibilities under existing law and managing the legal risks that may arise under existing law, as a result of the nature of their participation in the complex structured finance activities of a customer that involve violations of applicable law or other obligations. This Statement is not intended to and does not establish new legal responsibilities or liabilities for financial institutions, or create new crimes of action.

II. Definition and Key Risks of Complex Structured Finance Transactions

Structured finance transactions encompass a broad array of products with varying levels of complexity. This guidance addresses complex structured finance transactions, which usually share several common characteristics. First, they typically result in a final product that is often non-standard and structured to meet the specific financial objectives of a customer. Second, they often involve professionals from multiple disciplines within the financial institution and may have significant fees or high returns in relation to the market and credit risks associated with the transaction. Third, they may be associated with the creation or use of one or more special purpose entities (SPEs) designed to address the economic, legal, tax or accounting objectives of the customer and/or the combination of cash and derivative products. Finally, and perhaps most importantly, they may, in certain cases, expose the financial institution to elevated levels of market, credit, operational, legal or reputational risks. These criteria are not exclusive and institutions should supplement or modify these criteria as appropriate to reflect the institution's business activities and changes in the marketplace. A financial institution's policies and procedures for the review of complex structured finance transactions should be reasonably

designed to enable it to identify those complex structured finance transactions that present heightened risks warranting additional scrutiny ("Heightened Risk CSFTs"). Certain of the criteria and circumstances that institutions should consider in identifying Heightened Risk CSFTs are discussed in the section below entitled Reputational and Legal Risk.

Financial risks include, among other things, market and credit risks. Due to their inherent complexity, financial institutions participating in complex structured finance transactions also may face heightened reputational or legal risk. Financial institutions have been sued due to their involvement in complex structured finance transactions that allegedly facilitated the deceptive accounting or financial reporting practices of certain public companies. Legal risk also may arise in other situations if the financial institution is involved in transactions that are used by customers to circumvent regulatory or financial reporting requirements, evade tax liabilities, or further violate other illegal or improper behavior by the customer. legal obligations or by management of a customer to achieve objectives that violate management's obligations to shareholders.⁵ Besides creating legal risks, these transactions may create substantial reputational risk for the institution. Reputational risk poses a major threat to financial institutions because the nature of their business requires maintaining the confidence of customers, creditors and the general marketplace. Importantly,

⁵ For additional guidance concerning when a financial institution's participation in a complex structured finance transaction may violate the Federal securities laws, and the bases for such potential liability, see Letter from Annette L. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission, to Richard Spillenkothen and Douglas W. Roeder, dated December 4, 2003 (available at <http://www.federalreserve.gov/boarddocs/letters/2004/> and <http://www.sec.gov/press/2004/>).

⁶ For additional guidance concerning when a financial institution's participation in a complex structured finance transaction may violate the Federal securities laws, and the bases for such potential liability, see Letter from Annette L. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission, to Richard Spillenkothen and Douglas W. Roeder, dated December 4, 2003 (available at <http://www.federalreserve.gov/boarddocs/letters/2004/> and <http://www.sec.gov/press/2004/>).

reputational risks may arise even where the transactions involved are structured to technically comply with existing laws and regulations and accounting standards.

Accordingly, financial institutions need to have strong controls in order to ensure that conduct their actions with respect to complex structured finance transactions activities—including structuring, marketing, sales, funding and trading activities—are conducted in accordance with applicable laws and regulations, and to ensure that the institution identifies a risk policy, and to enable the institution to identify and appropriately addresses address the potential reputational risks involved in these transactions. As discussed further under "Reputational and Legal Risk," an institution's policies and procedures should identify those complex structured finance transactions that may Heightened Risk CSFTs that warrant enhanced scrutiny due to factors related specifically to reputational and legal risk.

Although the foregoing (and this document Statement more generally) highlights some of the most significant risks associated with complex structured finance transactions, it is not intended to present a full exposition of the risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory information prepared by the agencies Agencies for further information concerning market, credit, operational, legal and reputational risks.

III. Guidelines for Incorporating Structured Finance Transactions Into Existing Management Procedures, Controls and Systems

Role of Board and Management

The board of directors (the Board) of a financial institution is elected by and accountable to shareholders, and is the focal point of the corporate governance system. Effective oversight by the boards of directors of public institutions is fundamental to preserving the integrity of capital markets. The board of directors, in its oversight role, is ultimately responsible for the financial well being of the institutions they oversee, as well as ensuring that the risks associated with the firm's business activities, including those activities associated with the offering and delivery of complex structured finance transactions, are appropriately identified, evaluated and controlled by management. The Board should establish the financial

institution's threshold tolerance for the risks associated with complex structured finance products and ensure that a sufficiently strong mandate the establishment of a robust risk control framework is in place to guide the actions of the financial institution's personnel, and require the implementation of mechanisms to enable management to monitor the efficacy of the institution's control framework. The Board should ensure that the financial institution has a risk control framework for complex structured finance transactions that includes should include comprehensive policies that address the elements described below.

Using guidance provided by the Board, senior management should implement a risk control framework for complex structured finance transactions that includes comprehensive policies, defined roles and responsibilities and approval authorities, detailed management reporting, required documentation, and ongoing independent monitoring and testing of policy compliance. In order to manage the risks associated with complex structured finance transactions, some institutions have established a senior management committee that is designed to ensure that all of the relevant control functions within the financial institution, including independent risk management, accounting policy, legal, and financial control, are involved in the oversight of complex structured finance transactions Heightened Risk CSFTs. The goal of such a senior-level risk control committee is to ensure that those complex structured finance activities that may expose the financial institution to higher levels of financial, legal and reputational risk are comprehensively and consistently managed and controlled subject all Heightened Risk CSFTs to comprehensive and consistent management and control on a company-wide basis. This senior management committee regularly reviews trends in new products and complex structured transaction activity, including overall risk exposures from such transactions, and typically provides final approval of the most complicated or controversial complex structured finance transactions. The agencies Agencies believe that such a senior-level committee can serve as an important part of an effective control

infrastructure for complex structured finance activities.⁴¹

Financial institutions may implement elevated review of Heightened Risk CSFTs. Any such control processes should, however, involve independent control personnel, as well as personnel senior to or independent of the transacting business unit, in the review process.

The Board and senior management also should send a strong message to others in the financial institution about the importance of integrity, compliance with the law, and overall good business ethics, which may be implemented through a Code of Professional Conduct. The Board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical issues as well as the potential risks to the financial institution. The financial institution's culture and procedures should encourage personnel to elevate ethical concerns regarding a complex structured finance transaction or series of transactions to appropriate levels of management. Establishing a culture that encourages financial institution personnel to elevate concerns to appropriate levels of management may require mechanisms to protect personnel by permitting confidential disclosure in appropriate circumstances.⁴² Additionally, the Board and senior management should

endeavor to structure incentive plans so as to avoid, to the extent practical, incentivizing transactors to disregard legal or reputational risk considerations when executing complex structured finance transactions. Query: what is expected here?

Policies and Procedures

Financial institutions offering complex structured finance transactions should maintain a comprehensive set of formal,

⁴¹ Financial institutions should ensure that structure the control processes established they establish for complex structured finance activities as to comply with any informational barriers established by the institution to manage potential conflicts of interest, insider trading or other concerns.

⁴² The agencies Agencies note that the Sarbanes-Oxley Act of 2002 requires companies listed on a national securities exchange or inter-dealer quotation system of a national securities association to establish procedures that enable employees to submit concerns regarding questionable accounting or auditing matters on a confidential, anonymous basis. See 15 U.S.C. 78j-1(m).

firm-wide policies and procedures that provide for the identification, documentation, evaluation, and control of the full range of credit, market, operational, legal, and reputational risks that may be associated with these transactions. These policies should start with the financial institution's definition of what constitutes a complex structured finance transaction and be designed to ensure that enable the financial institution to appropriately manage manage its complex structured finance activities on both an individual transaction and a relationship basis, with all corporate customers (including publicly and privately owned corporate entities, government entities and individuals) and in all jurisdictions where the financial institution operates.⁴³ These policies may be developed specifically for complex structured finance transactions or included in the set of broader policies governing the institution generally.

To be most effective, the institution's policies and procedures relating to complex structured finance transactions should specifically set forth the particular responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of these transactions.

Accordingly, these policies and procedures should address responsibilities of personnel from sales and trading, relationship management, market risk, credit risk, operations, accounting, legal, compliance, audit and senior line management. The financial institution's policies and procedures should provide a clear framework for the approval and monitoring of complex structured finance transactions. Policies for relevant personnel should describe responsibilities for working with relationship managers, advising and counseling customers, disclosing information to customers, and providing relevant information to control areas.

The institution's policies should ensure that provide for the appropriate identification, aggregation and management of the market, credit, and operational risk associated with individual complex structured transactions are appropriately identified, aggregated, and managed. A financial institution should, at

⁴³ In the case of U.S. branches and agencies of foreign banks, these policies should be coordinated with the group-wide policies developed in accordance with the rules of the foreign bank's home supervisor.

a minimum, also have procedures, controls and systems for complex structured finance activities that address the following: (1) Transaction approval, (2) new product approval, (3) reputational and legal risk, (4) accounting and disclosure by the customer, (5) documentation, (6) reporting, (7) independent monitoring, analysis and compliance with internal policies, (8) audit, and (9) training.

Transaction Approval

The policies and procedures of a financial institution should define the process that personnel must follow to obtain approval for a complex structured finance transaction. Policies for approving complex structured finance transactions should clearly articulate the roles and responsibilities of both transactors (e.g. personnel from origination, structuring, execution, sales and trading areas) and independent control staff (e.g. personnel from risk management, accounting policy, legal, and financial control) in analyzing, approving, and documenting proposed transactions. Policies should guide front office personnel in meeting their responsibilities to provide information on customer objectives and key risk issues (including those described below) to the appropriate approving personnel. Furthermore, it is imperative that the approving authority for **Heightened Risk CSFTs** includes representatives from appropriate control areas that are independent of the transactors. Approving personnel should have appropriate experience and stature in the financial institution to ensure provide proper consideration of elements or factors that may expose the institution to higher levels of credit, market, operational, legal or reputational risk. While acknowledging its ultimate responsibility for the approval of complex structured finance transactions, the organization's policies also should clearly outline when include policies and procedures governing the engagement of third-party legal professionals should be engaged to review and opine on transactions, and when third-party tax and accounting or tax professionals should be engaged experts to consult on transactions in appropriate circumstances.

New Product Policies

Complex structured finance transactions also should be incorporated into a financial institution's new product policies. In this regard, a financial institution's policies should include a definition of what

constitutes a "new" complex structured finance product and should establish a control process for the approval of each new product. In determining whether or not a complex structured finance transaction is "new," a financial institution should consider a variety of factors, including Such factors may include, for example, any structural variations from existing products, whether the product is targeted at a new class of customers, pricing variations from existing products, whether the product raises additional or new legal, compliance or regulatory issues, and deviations from standard market practices. When in doubt as to whether a complex structured finance transaction requires vetting through the new product approval process, financial institution personnel should err on the side of conservatism and be instructed to raise the issue with more senior, or other designated, personnel for guidance in determining whether to route the proposed product through the process dictated in the new product approval policy. The new product policies for complex structured finance activities should address the roles and responsibilities of all relevant parties, including the front office, credit risk, market risk, operations, accounting, legal, compliance, audit and senior line management. In addition, it is imperative that the institution's policies require that new products receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

A financial institution also should have in place controls that are reasonably designed to ensure that subject all new complex structured finance products are, in fact, subjected to the institution's established approval process. Moreover, subsequent to the new product approval, the financial institution should monitor new complex structured finance products to ensure confirm that they are effectively incorporated into the institution's risk control systems.

Reputational and Legal Risk

The

Complex structured finance transactions may present heightened legal and reputational risks for financial institutions. These risks may arise from the financial institution's failure to comply with existing laws applicable to it or from the nature of the financial institution's involvement in a transaction in which the financial institution's

customer (or its management), fails to comply with applicable law or other obligations.

Heightened legal and reputational risks may arise from a number of sources to which financial institutions should be alert. They may arise from a customer's proposed tax, regulatory or accounting treatment for a transaction, or the manner in which a customer proposes to disclose the impact of a complex structured finance transaction in its financial statements. They may also arise in circumstances where a customer's management acts in a manner that violates management's obligations to shareholders of the customer.

A financial institution that promotes a transaction structure that is specifically tailored to accomplish a particular tax, accounting or regulatory objective assumes related legal and reputational risks. In that context, the financial institution's policies and procedures established by a financial institution for complex structured finance activities should ensure that the legal and reputational risks associated with a transaction, or series of transactions, are identified and evaluated in both the transaction and new product approval processes and effectively and appropriately managed by the institution. A financial institution should have effective policies, procedures and controls for assessing the customer's business objectives for entering into a transaction or series of transactions and the economic substance of the transaction(s), evaluating the appropriateness of the transaction(s), and preventing the financial institution from participating in inappropriate transactions should be designed to provide a reasonable level of confidence that the proposed transactional structuring objective comports with relevant accounting, tax or legal standards of general application. These policies and procedures should require the involvement of independent control personnel and such outside advisors and experts as management of the relevant business unit or control function may determine appropriate for this purpose.

Policies should ensure that the customer understands the risk and return profile of the transaction. A financial

institution that undertakes responsibility to design a complex structured finance transaction to accomplish a particular customer's specific tax, accounting or regulatory objective may also subject itself to heightened contractual responsibilities and attendant liabilities in that role. In instances where the financial institution is designing the transaction and advising the customer, the disclosures to the customer should include financial institution should, in addition to the policies and procedures described above, obtain from the customer and retain¹⁰ such information as the financial institution may require for the purpose of designing the relevant transaction. The financial institution should additionally provide to its customer an adequate description of the material economic characteristics and risks in of the proposed complex structured finance transaction as well as disclosure of any and disclose any material conflicts of interest associated with the financial institution's participation in the transaction. Policies should also articulate when a proposed transaction requires acknowledgement by the customer that the transaction has been reviewed and approved by higher levels of the customer's management. Notwithstanding a customer's sophistication and structure of a and should take steps to confirm that the transaction, and any related risks, are understood at an appropriate level of management at the customer.

Similarly, a financial institution should have policies and procedures that are designed to address situations in which the financial institution believes, based on the information available to it, that a customer may not understand the terms, characteristics or risks of a proposed complex structured finance transaction. In such cases as well, the financial institution should take steps to confirm that the transaction and attendant risks are understood at an appropriate level of management at the customer. If, following such steps, the customer determines to pursue the transaction, the financial institution should refer the transaction for elevated review within the financial institution. If

¹⁰ The policies and procedures of a financial institution should specify the periods for retention of records and documents consistent with applicable legal requirements.

the financial institution proceeds with the transaction, it should document and retain its own analysis and the information it has provided to the customer.¹¹

Applicable law, such as the Internal Revenue Code and rules thereunder, in the case of material advisors, the Securities Act of 1933, in the case of underwriters, and self-regulatory organization rules, in the case of securities firms, among others, may impose specific responsibilities directly on financial institutions in connection with complex structured finance transaction, the financial institution should evaluate the impact a transaction may have on the financial institution's reputation or franchise value activities, depending on the circumstances of the transaction and the nature of the financial institution's role in the transaction. Similarly, statutes and common law may impose liability on a financial institution that knowingly provides substantial assistance to a customer that is engaged in a violation of applicable law.¹² Financial institutions should have policies and procedures designed to familiarize personnel with these responsibilities and liabilities, to effect compliance with such responsibilities and to protect the institution from incurring such liabilities.

Policies should outline responsibilities of the sales force, front office, credit and other risk control personnel for analyzing and documenting the customer's objectives and customer-related accounting, regulatory, or tax issues. In addition, a financial institution's policies and procedures should establish criteria or factors for when concerns related to a particular structured finance transaction will necessitate a comprehensive evaluation of the institution's entire relationship with a customer.

Policies should ensure that complex structured finance transactions are reviewed on a consistent basis by the

¹¹ See, e.g., Office of the Comptroller of the Currency Banking Circular 277, Risk Management of Financial Derivatives.

¹² Specific legal standards for primary or secondary liability may vary by statute or jurisdiction.

financial institution's legal department and, where appropriate, by independent outside counsel. In general, the financial institution's legal department should review complex structured finance transactions as part of the approval process. Legal personnel may be assigned to business units or areas where complex structured transactions originate to ensure the legal department's involvement throughout the transaction's development, or financial institutions may assign specific legal personnel to each complex structured finance transaction. Independent monitoring by a risk control group or compliance unit should ensure that all complex structured transactions receive appropriate legal review, including review by outside counsel where appropriate.

Areas for legal review include financial institution permissibility, disclosure by the customer, regulatory capital requirements, the enforceability of any netting and collateral agreements associated with the transaction, suitability or appropriateness assessments, customer assurances, insurance considerations and tax issues. Because transactions may involve multiple counterparties located in different jurisdictions, the financial institution should establish review and documentation procedures that are designed to ensure that each counterparty has the authority to enter into the transaction and that each counterparty's obligations are reduced to legally enforceable contracts. Financial institutions should ensure that any legal reviews are conducted by qualified in-house or outside counsel and that these professionals are provided the documentation and other information needed to properly evaluate the transaction.

A financial institution that becomes aware of facts that raise questions as to whether its customer may be engaged in, or intend to engage in, conduct that is likely to violate applicable law or other obligations or otherwise create reputational risk for the financial institution, should take appropriate steps to identify, evaluate and address such

legal and reputational risks and should have in place an effective framework of policies and procedures for doing so.

[Following section moved to follow high risk characteristics section below.]

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 Policies should identify criteria to consider in determining whether approval of a complex structured finance transaction, or series of transactions, should be elevated to higher levels of financial institution management for reasons specific to legal or reputational risk, in addition to those circumstances in which the financial institution is specifically aware of facts that raise questions as to whether its customer may be engaged in, or intend to engage in, conduct that would violate applicable law or other obligations or otherwise create legal or reputational risk. In creating procedures for elevating certain transactions such as Heightened Risk CSFTs to higher levels of scrutiny, financial institutions should identify the characteristics of those transactions, or series of transactions, that increase reputational and legal risk. Institutions should be conservative when draw on the resources of experienced personnel in identifying these characteristics. While institutions may differ in the sets of characteristics they identify, the goals should remain the same—to identify the transactions that require additional scrutiny at inception and to ensure that transactions receive subject such Heightened Risk CSFTs to a level of review that is commensurate with the legal and reputational risks associated with the transaction and the nature and scope of the institution's role in the transaction. Examples of characteristics that should be considered in determining whether or not a transaction or series of transactions might need additional scrutiny include:

- Transactions with questionable economic substance or business purpose or designed primarily to exploit achieve questionable accounting, regulatory or tax guidelines objectives (particularly when executed at year end or at the end of a reporting period);

- Transactions that require an equity capital commitment from the financial institution that is unusual in the context of the relevant type of transaction;

- Transactions with terms inconsistent with market norms (e.g., deep "in the money" options, non standard settlement dates, non-standard forward-rate rolls), other than for legitimate and apparent business objectives;

- Transactions, for which standard documentation exists, using non-standard legal agreements (e.g., customer insists on using its own documents that deviate from market norms), other than for legitimate and apparent business objectives;

- Transactions involving multiple obligors or otherwise lacking transparency (e.g., use of SPEs or limited partnerships), other than for legitimate and apparent business objectives;

- Transactions with unusual profits or losses or transactions that give rise to compensation that appears disproportionate to the services provided or, to the risk assumed by the institution, or the innovative character of the transaction;

- Transactions that raise concerns about how the client will report or disclose the transaction (e.g., derivatives with a funding component, restructuring trades with mark to market losses);

- Transactions with unusually short time horizons or potentially circular transfers of risk (either between the financial institution and customer or between the customer and other related parties);

- Transactions with oral or undocumented agreements, which, if documented, could have material legal, reputational, financial accounting, financial disclosure, or tax implications;¹³

- Transactions that cross multiple geographic or regulatory jurisdictions, making processing and oversight difficult;

¹³—This item is not intended to include traditional, non-binding "comfort" letters provided to financial institutions in the loan process where, for example, the parent of a loan customer states that the customer (i.e., the parent subsidiary) is an integral and important part of the parent's operations.

¹³ This item is not intended to include traditional, non-binding "comfort" letters provided to financial institutions in the loan process where, for example, the parent of a loan customer states that the customer (i.e., the parent subsidiary) is an integral and important part of the parent's operations.

other than for legitimate and apparent business objectives;

- Transactions that cannot be processed via established operations systems; and

- Transactions with significant leverage unusual leverage.

Although characteristics, such as those enumerated immediately above, should be taken into consideration in evaluating individual complex structured finance transactions, none of the foregoing characteristics, individually or in combination, will necessarily indicate the existence of heightened legal or reputational risk requiring an elevated level of review. The determination whether one or more such characteristics — or other characteristics — gives rise to heightened legal or reputational risks should be made by those involved in the transaction approval process for the relevant business unit, in consultation with such independent control personnel or outside advisors as the business unit determines appropriate under the circumstances, based on the facts and circumstances of the particular transaction and the information known to the transaction.

Having developed a process to identify transactions Heightened Risk CSFTs that may pose higher levels of legal and reputational risk, financial institutions should implement procedures to address these risks. These procedures should, among other things, be reasonably designed so that:

- Ensure that staff approving each transaction fully understands the scope of the institution's relationship with the customer and has evaluated and documented the customer's business objectives for entering into the transaction, the economic substance of the transaction, and the potential legal and reputational risks Staff approving any Heightened Risk CSFT conducts a thorough evaluation of the transaction features or other considerations identified as presenting heightened legal or reputational risk to the financial institution;

- Ensure There is a thorough review and evaluation of whether credit exceptions, accounting issues, rating agency disclosures, law suits against the customer, or other factors expose the financial institution to unwarranted legal or reputational risks.

- Develop and implement effective Effective internal communication procedures to ensure are developed and implemented so that all financial institution personnel responsible for transaction approval and monitoring receive, and document in a timely manner, complete and accurate appropriate information about the transaction, the customer's purpose(s) for entering into the particular transaction, and the materiality of the transaction to the customer;

- Ensure sufficient Sufficient time is allowed for a detailed, thorough review of the transaction by the relevant personnel;

- Ensure that complex Complex structured finance transactions identified as having heightened risks receive a thorough review by senior management for an evaluation of credit, market, operation, legal and reputational risks to the financial institution;

- Ensure that complex Complex structured finance transactions that are determined to present unacceptable risk to the financial institution are declined;

- Ensure that the The Board and senior management periodically assess the financial institution's tolerance for risks associated with complex structured finance transactions; and

- Ensure that the institution provides the customer with appropriate information concerning the structure and risks of the transaction, and articulate when a proposed transaction requires acknowledgement of review by higher levels of a customer's management. [Deleted as now redundant]

[Following text moved from preceding section: Note: We believe the following is overly prescriptive and unnecessary in light of the earlier requirement that an institution's policies must specify the roles and responsibilities of personnel (including control personnel). Policies should outline responsibilities of the sales force, front office, credit and other risk control personnel in connection with the management of the legal and reputational risks associated with complex structured finance transactions. In addition, a financial institution's policies and procedures should establish criteria or processes for determining whether concerns related to a particular structured finance transaction will necessitate a comprehensive

evaluation of the institution's entire relationship with a customer

Policies should require that complex structured finance transactions be reviewed on a consistent basis by the financial institution's legal department and, where appropriate, by independent outside counsel. In general, the financial institution's legal department should review complex structured finance transactions as part of the approval process. Legal personnel may be assigned to business units or areas where complex structured transactions originate to ensure the legal department's involvement throughout the transaction's development, or financial institutions may assign specific legal personnel to each complex structured finance transaction. Independent monitoring by a risk control group or compliance unit should ensure that all complex structured transactions receive appropriate legal review, including review by outside counsel where appropriate.

Areas for legal review include financial institution permissibility, disclosure by the customer, regulatory capital requirements, the enforceability of any netting and collateral agreements associated with the transaction, suitability or appropriateness assessments, customer assurances, insurance considerations and tax issues. Because transactions may involve multiple counterparties located in different jurisdictions, the financial institution should establish review and documentation procedures that are designed to ensure that each counterparty has the authority to enter into the transaction and that each counterparty's obligations are reduced to legally enforceable contracts. Financial institutions should ensure that any legal reviews are conducted by qualified in-house or outside counsel and that these professionals are provided the documentation and other information needed to properly evaluate the transaction.

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.]

Accounting and Disclosure by Customers

As noted above, complex structured finance transactions designed primarily to achieve financial reporting or complex tax objectives may require greater scrutiny due to possible legal and reputational risk implications. For transactions identified as involving elevated risks Heightened Risk CSFTs, the financial institution's

procedures should ensure that require staff approving the transactions 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 such information as it determines appropriate to evaluate the issue or considerations giving rise to heightened legal or reputational risk to the institution. The institution's policies should ensure that provide for this information to be assessed by appropriate personnel in the approval process and that for these personnel to consider the information in light of financial, accounting, rating agency disclosure, or other information associated with the transaction that may raise legal or reputational risks for the financial institution.

The financial institution's policies also should address when third party accounting professionals should be engaged to review transactions. Moreover, there may be circumstances where the financial institution or the third party accounting professionals it engages will wish to communicate directly with the customer's independent auditors to discuss the transaction. Independent monitoring of the approval process (discussed below) should ensure be designed to confirm that personnel adhere to established requirements for obtaining a review by third party accountants or communicating with the customer's independent auditor approval

In any instance where the financial institution determines that a proposed transaction may is likely to result in the customer filing materially misleading financial statements, the financial institution should take appropriate actions. Such actions may include declining to participate in the transaction or conditioning its participation upon the customer making express and accurate disclosures regarding the nature and financial impact of the transaction on the customer's financial condition providing reasonable assurances regarding its prospective disclosure. The ultimate objective is to take steps to ensure that protect the financial institution does not participate in an inappropriate from participating in a transaction that presents

unacceptable legal or reputational risk.

As part of this process, financial institutions should consider seeking representations and warranties from the customer stating the purpose of the transaction, how the customer will account for the transaction, and that the customer will account for the transaction in accordance with applicable accounting standards, consistently applied.¹⁴

The financial institution also should develop procedures to address the creation, acquisition, and use of institution and client-sponsored SPEs. When a structured transaction requires the establishment of such an entity, the financial institution should implement an SPE approval process that permits the risk control groups to evaluate the accounting, legal, and tax issues. Effective review may protect the financial institution against accounting, legal, tax, and reputational risks. Financial institutions should also monitor the use of SPEs by providing periodic updates to executive management and maintaining a database of all SPEs created to facilitate structured finance transactions.

Documentation Standards

The documentation that financial institutions use to support complex structured finance transactions is often highly customized and negotiated. Careful generation, collection and retention of documents associated with complex structured finance transactions are important control mechanisms in minimizing legal and credit risks, as well as reducing unwarranted exposures to the financial institution's reputation. Policies and procedures should ensure that transaction documentation is appropriately detailed and transparent for review by all control or approval functions. When in doubt, financial institutions should err on the side of conservatism and retain documents associated with transaction due diligence, approval and monitoring. **Financial institutions should maintain comprehensive documentation for all transactions approved, as well as disapproved transactions with controversial elements (e.g., denied in the final stages of approval or due to customer requests for particular terms requiring additional scrutiny) records that document: (1) the material terms of any approved transaction (or such other**

records as an institution's policies specify as evidence of the terms of transactions submitted for approval; (2) if the transaction is approved subject in conditions,¹⁵ the relevant conditions and records of their satisfaction; and (3) a record of the agenda for, and final actions taken at, meetings at which complex structured finance transactions are reviewed and acted upon.

The documentation policies of a financial institution should seek to ensure that all counterparty obligations are reduced to legally enforceable written contracts. This would include the use of term sheets, confirmations, master agreements, netting agreements, and collateral agreements or comparable documents. An institution should have systems in place to track the status of documentation on a deal-by-deal basis to ensure that counterparties execute and return all necessary contractual documents. The responsibility for drafting transaction documents, or selecting appropriate templates, should be assigned to personnel who can identify legal issues (e.g., enforcing collateral or netting agreements in foreign jurisdictions), and have been given guidance on when to escalate issues involving the drafting process to higher level legal staff or management. Financial institutions that engage in a significant number of complex structured finance transactions may find it beneficial to establish a specialized documentation unit.

The financial institution's documentation standards also should clearly assign accountability and strive for transparency in the approval process and ongoing monitoring of exposures associated with complex structured finance transactions. Such standards should include appropriate guidance on:^{14a}

- Generation, distribution and retention of documents associated with individual transactions. In addition to standard legal documents, such documentation should include, as appropriate:

- Deal summary, including a list of deal terms

- Analysis or opinions (both formal and informal), prepared internally or by third parties, regarding legal considerations, tax and accounting treatments, market viability and regulatory capital requirements for any and all parties

- Marketing materials and other key documents provided to the customer

- Internal and external correspondence, including electronic communications, regarding transaction development and due diligence

- Transaction and credit approvals (including any documentation of actions taken to mitigate initial concerns, such as providing additional client disclosures or changing deal structures)

- Minutes of critical meetings with the client

- Disclosures provided to the customer (including side letters or other documents addressing terms or conditions of the transactions), including disclosures of all conflicts of interest and descriptions of the terms of the complex structured finance transactions

- Acknowledgements received from the customer concerning the accounting, tax, or regulatory implications associated with the transaction

- Generation, distribution and retention of documents such as minutes of meetings of committees and control groups prepared in sufficient detail to indicate issues raised, approval or rejection of a transaction, rationale or factors considered in approving or rejecting a transaction and contingencies or items to be resolved pending final approval. It may be practical to assign a specific coordinator or central location for the maintenance of committee and control group minutes.

- Generation, distribution and retention of information demonstrating final resolution of items still pending at time of transaction approval.

- Generation, distribution and retention of key documents associated with ongoing communications with the customer.

- Generation, distribution and retention of key documents showing the financial institution's monitoring of exposures and periodic assessment of reputational and legal risk considerations

Reporting

Regardless of the approval structure, the financial institution should define the complex structured finance transaction reporting requirements appropriate for

¹⁴ Of course, financial institutions also should ensure that the institution's own accounting for transactions complies with applicable accounting standards, consistently applied.

¹⁵ In this context, conditions might include contractual provisions, representations or warranties, or legal or other expert opinions or advice, as the relevant decision makers determine appropriate under the circumstances.

^{14a} Of course, financial institutions must continue to comply with all applicable laws and regulations governing the making and keeping of records and reports.

various levels of management and the Board. Financial institutions should develop and ensure that provide for reports summarizing pending and contemplated complex structured finance transactions are to be disseminated to appropriate levels of management for their review and further distribution. At a minimum, the financial institution should establish an independent risk function that prepares a periodic summary of significant trends in complex structured finance transactions and a brief summary of each consummated deal determined to involve heightened risks. In addition, management should establish a process for reporting transactions viewed as possessing higher risk.

Independent Monitoring, Analysis, and Compliance With Internal Policies

The events of recent years evidence the need for a strong compliance function in those financial institutions engaged in complex structured finance transactions. Financial institutions should develop and enforce procedures to conduct periodic independent reviews of complex structured finance business activity to ensure confirm that policies and controls are being implemented effectively and to identify complex structured transactions that may have been executed without proper approvals or which may indicate problematic trends. These reviews should cover all the processes involved in creating, analyzing, offering and marketing complex structured finance products. Procedures should identify departments and personnel responsible for conducting reviews and surveillance. Generally, compliance management oversees this monitoring and analysis, with considerable assistance from personnel in finance and operations.

The establishment of an independent monitoring and analysis program often requires considerable work, as unique reports often need to be set up for specialized products. Elevated monitoring should be directed to those transactions or relationships that the financial institution has identified as presenting heightened legal or reputational risks, based on the factors and considerations discussed above under "Reputational and Legal Risks," or where the transaction or patterns series of transactions pose greater credit or market risk. Such monitoring may include more frequent assessments of customer exposures and elevation of findings to a higher level of management in the financial institution.

Compliance functions often are organized along product lines, and this structure may prove challenging when offering complex structured finance transactions that cross product lines. Practices that may assist financial institutions in establishing proactive compliance functions include, but are not limited to:

- Assigning onsite compliance officers for each traded product or business line and establishing a process for communication across product lines, legal entities, or regions
- Developing comprehensive compliance programs that address responsibilities for risk assessment, identifying and managing conflicts of interest, and require policy implementation, training, monitoring and testing
- Establishing clear policies that govern product and transaction approval, require the pre-approval of higher risk transactions, and define standards for marketing materials
- Conducting periodic reviews of derivatives and complex structured transaction documentation and policy compliance
- Reviewing trading activity to identify off market trades, synthetic funding transactions, unusually profitable trades and customer relationships and trades that present reputational concerns
- Conducting a periodic assessment of the supervision of sales and trading personnel and policy compliance.

Audit

The internal audit department of any financial institution is integral to its defense against fraud, unauthorized risk taking and damage to the financial institution's reputation. These are all areas of concern with respect to complex structured finance activities. The complexity and relative profitability of these activities may add to the difficulty of analysis and increase the incentives for risk taking. For these reasons, the internal audit department in conducting its review of complex structured finance activities should audit the financial institution's adherence to its own control procedures, and further assess the adequacy of its policies and procedures given the nature of its complex structured finance business.

Effective internal audit coverage of complex structured finance transactions requires a comprehensive independent audit program that is staffed with personnel that

have the necessary skills and experience to identify and report on compliance with financial institution policy and procedures. These necessary skills and experience should include an understanding of the nature and risks of structured transactions, as well as a detailed understanding of the institution's policies and procedures. Internal audit should validate that all business lines and individual desks are complying with the financial institution's standards for complex structured finance transactions and appropriately identify any exceptions. This validation should include transaction testing that confirms policy compliance, the existence of proper approvals, the adequacy of documentation, and the integrity of management reporting. Internal audit should have well-articulated procedures for when to expand the scope of audit activities. Further, internal audit should have procedures for reporting audit findings directly to the financial institution's audit committee and senior management of the audited area.

Internal audit should implement follow-up procedures to ensure confirm that audit findings have been resolved and the business unit or department has implemented audit recommendations in a timely manner.

In addition, the complexity of the structured finance activities may cause financial institutions to retain outside consultants, accountants, or lawyers to review the structured product area. The retention of such independent expertise may be a prudent method to fully grasp and control the overall risk resulting from such activities. For example, financial institutions may employ external auditors to test the structured transactions approval process and ensure verify compliance with its policies and procedures.

The resulting reports and memoranda can provide valuable insight to the financial institution in improving its risk controls and oversight.

Training

Appropriate training on the financial institution's policies and procedures for handling complex structured finance transactions is critical. At the inception of a complex structured finance transaction, financial institution personnel should be aware of the required approval process needed for transaction implementation. The financial institution should retain documentation to support the initial and ongoing training of personnel involved in complex structured finance transactions.

Summary

Financial institutions play a critical role in ~~ensuring~~ the integrity of our financial markets. The ability of financial institutions to fulfill this role and operate in a prudent manner depends on a foundation built upon trust and public confidence and compliance

with all applicable legal requirements. The regulatory agencies expect financial institutions involved in structured finance transactions to build and implement enhanced risk management and internal controls systems that effectively ~~ensure~~

~~compliance~~ are effective in enabling institutions to comply with the law and control the risks associated with complex structured finance transactions.