

Clients & Friends Memo

Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities

May 16, 2006 On May 9, 2006, 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 Securities and Exchange Commission (collectively, the “Agencies”) issued for public comment a revised proposed “Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities” (the “Revised Proposal”).¹ The Agencies had issued an initial proposal on May 19, 2004 (the “Initial Proposal”). After extending the comment period for the Initial Proposal, the Agencies apparently considered that the significant number of negative public comments made impossible finalizing an amended version of the Initial Proposal. Instead, they issued the Revised Proposal, on which comment is due within 30 days from formal publication of the Revised Proposal in the Federal Register.

Summary

The Initial Proposal was released by the Agencies in the wake of several large scandals involving structured financings arranged or sold by financial institutions. The Agencies stated that certain structured financings had exposed financial institutions to excess legal and reputational risks, and that the involved financial institutions had not effectively managed those risks. The Initial Proposal was seen by the financial institutions to be covered by it as a significant but vague expansion of duties and responsibilities of those financial institutions, which potentially created new avenues for plaintiffs to sue them. The public comments provided on the Initial Proposal were almost uniform in their acceptance of the supervisory concepts involved, but negative on their proposed implementation.

The Revised Proposal addresses many of the complaints of the Initial Proposal. For example, the Revised Proposal explicitly states that it is not intended to create new duties for financial institutions, and does not create a new private right of action against them. Further, the Revised Proposal is more narrowly focused on certain “high risk” structured finance transactions and the

¹ The Revised Proposal applies to national banks, state banks, bank holding companies, federal and state savings institutions, savings and loan holding companies, U.S. branches and agencies of foreign banks, and broker-dealers and investment advisors registered with the Securities and Exchange Commission.

financial institutions that engage in them. However, financial institutions will likely still find the Revised Proposal vague in many important aspects. Of most importance, the Revised Proposal continues to require that financial institutions investigate, and bear some responsibility for, their clients' proposed tax, accounting and legal analysis of certain structured financings. Most of the recommendations of the Revised Proposal are likely in place at many of the financial institutions to be covered by it.

Description

The Initial Proposal

In light of the roles certain financial institutions were alleged to play in the some of the significant public company scandals and bankruptcies of the early 2000's, the Agencies issued the Initial Proposal to assist financial institutions in developing policies, procedures and internal controls to identify, manage and address heightened reputational and legal risks from engaging in complex structured finance transactions ("CSFTs") with their clients. The Agencies noted that when financial institutions participate in CSFTs, they may face increased risks, especially if their customers' treatment of the transaction for regulatory, tax, disclosure or accounting purposes do not comply with applicable laws. Some of the CSFTs appeared to have been used in illegal schemes designed to misrepresent the financial condition of the public companies to investors. In response to the increased risks associated with certain CSFTs, financial institutions began upgrading their internal policies and controls.

To provide guidance to managing these risks, the Initial Proposal provided detail concerning the need for and substance of internal controls. In particular, it provided that financial institutions engaged in CSFTs should maintain formal, written policies and procedures designed to assist them in identifying and managing the credit, market, operational, legal and reputational risks inherent in those types of transactions. Certain specific areas to be covered were identified: (i) transaction approval; (ii) new complex structured finance product approval; (iii) management of legal and reputational risk from CSFTs; (iv) review of customer's proposed accounting and disclosures for CSFTs; (v) documentation of CSFTs; (vi) management reporting for CSFTs; (vii) independent monitoring of compliance with internal CSFT policies and procedures; (viii) role of internal audit; and (ix) personnel training.

While the commentators were generally in favor of the concepts behind the Initial Proposal, they were almost uniformly negative concerning its proposed application. Commenters stated that the proposal covered too many plain vanilla transactions that did not raise heightened risks to the participants and could be read to cover almost any special purpose vehicle used in a financing. Similarly, commenters complained that the proposed internal controls and reviews did not distinguish between the different roles that financial institutions could play in CSFTs. They also found inappropriate the proposed new duties to confirm the validity of a customer's disclosure or

treatment of a CSFT. In sum, commenters complained that the Initial Proposal could actually increase the legal risks to financial institutions through imposing difficult to implement standards, could disrupt the market for legitimate CSFTs and might place U.S. financial institutions at a competitive disadvantage in the CSFT markets.

The Revised Proposal

The Revised Proposal is substantially revised from the Initial Proposal, and takes to heart many of the issues raised by the commenters. Perhaps most importantly, the Revised Proposal limits its application to those CSFTs that pose heightened legal or reputational risks to financial institutions (the “elevated risk CSFTs”). This narrowing of the focus excludes most structured finance transactions that are “plain vanilla” transactions or have well-established track records permitting easy identification and management of their risks. In addition, as only a handful of sophisticated financial institutions engage in elevated risk CSFTs, the vast majority of financial institutions will not be covered by the Revised Proposal. Further, covered financial institutions should tailor the requirements of the proposals to their actual activities: entities structuring elevated risk CSFTs face significantly more risk than do financial institutions that merely provide funding or other services to a covered transaction.

The Revised Proposal borrows heavily from policies and procedures already required by the Agencies for many activities. These internal controls have been found to be effective methods of identifying and managing risks, and should be emphasized for elevated risk CSFTs. The Agencies recognize that many of the covered financial institutions have already implemented most if not all of the internal controls suggested in the Revised Proposal.

Tellingly, the Revised Proposal prominently states that it “does not create any private rights of action, and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other third parties under applicable law.” This statement appears to be in direct response to comments from many financial institutions that the requirements of the Initial Proposal could be used by plaintiffs to state claims against them.

The general responsibility outlined under the Revised Proposal is for financial institutions to have formal firm-wide policies and procedures that are designed to identify, evaluate, assess, document and control the risks (credit, market, operational, legal and reputational) associated with elevated risk CSFTs. These policies and procedures should be tailored to address the institution’s specific activities or, if it is operating in foreign jurisdictions, to comply with applicable laws and regulations. A financial institution that structures, markets, acts as an advisor or otherwise plays a substantial role in a transaction may have additional information concerning the client’s business purpose or intended accounting, tax or regulatory treatment or disclosure for the transaction, and therefore is in a better position to identify elevated risk CSFTs than would be a financial institution in a more limited role.

Covered financial institutions will have to develop clear frameworks for reviewing and approving elevated risk CSFTs. This includes defining such products so that they may be identified by appropriate personnel and placed in the new product approval process. The Revised Proposal spends considerable time highlighting the factors that should alert financial institutions that they are dealing with elevated risk CSFTs. Examples include transactions that: (i) lack economic substance or business purpose; (ii) are designed or used primarily for *questionable* accounting, tax, or regulatory objectives; (iii) raise concerns that the client will report or disclose the transaction in a materially misleading or inconsistent manner; (iv) involve oral or undocumented agreements that would have a material impact on the regulatory, tax or accounting treatment of the related transaction or disclosure; (v) include material economic terms that are inconsistent with market terms; or (vi) provide the financial institution with compensation “substantially disproportionate” to its role in the transaction.

Once an elevated risk CSFT is identified, the Revised Proposal requires financial institutions to conduct a “heightened level of due diligence” on them. The Revised Proposal focuses on what this level of due diligence includes. The level and amount of due diligence performed should be commensurate with the level of risks involved. The greater the role of a financial institution in an elevated risk CSFT, the greater its legal or reputational exposure may be, and it should then exercise a higher degree of care in conducting its due diligence of the transaction. Due diligence may include obtaining additional information from the customer or specialized advice from outside professionals on accounting, tax, legal or regulatory issues. Notwithstanding this guidance, the Revised Proposal indicates that it may not always be appropriate for a financial institution to rely on opinions or analyses prepared by or for the customer on these topics. In any event, a financial institution must independently analyze the potential risks from the overall relationship with the customer, inclusive of the proposed transaction.

Once reviewed and investigated, elevated risk CSFTs should be approved by appropriate levels of management that include both relevant business lines and personnel independent of any affected business line. Appropriately expert subject matter personnel should be consulted as well. The Revised Proposal indicates that some financial institutions have set up dedicated senior level approval committees solely to review and approve elevated risk CSFTs, though such a committee is not required.

If participation in an elevated risk CSFT would raise significant legal or reputational risks to a financial institution, it must either (i) decline to participate or (ii) condition its participation on receipt of “representations or assurances from the customer that reasonably address the heightened” risks before execution of any commitments. A financial institution should in all circumstances decline to participate in a transaction if the transaction presents unacceptable risks or would result in a violation of applicable laws, regulations or accounting principles.

Finally, the Revised Proposal notes that financial institutions should carefully review all documentation as part of elevated risk CSFTs, should have the board and senior management set appropriate business ethics for all transactions including CSFTs, should strengthen and monitor internal audit and compliance with internal controls, policies and procedures, and should ensure that relevant personnel receive effective training.

Conclusion

The Revised Proposal attempts to fix many of the issues raised by commenters from the Initial Proposal. The Revised Proposal is much more narrowly focused on high risk transactions and the financial institutions that play significant roles in them. Many of the points in the Revised Proposal are effective risk management tools that are already in place at many financial institutions. However, numerous issues remain. Perhaps the most significant is that the Revised Proposal continues to require financial institutions to investigate the motives of their customers, without explaining how such diligence may be effectively performed. It also risks being used by parties wishing to sue financial institutions as creating new standards that, in retrospect, will often appear to have been violated by financial institutions, notwithstanding the disclaimer quoted above.

If you have any questions regarding this matter, please contact a member of the Capital Markets Department.