

# Clients & Friends Memo

## **Policy Statement: Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities**

**May 27, 2004** The Office of the Comptroller of the Currency, Treasury (“OCC”), the Office of Thrift Supervision, Treasury (“OTS”), the Board of Governors of the Federal Reserve System (“Federal Reserve”), the Federal Deposit Insurance Corporation (“FDIC”), and the Securities and Exchange Commission (“SEC”) (collectively, the “Agencies”) have requested public comment regarding a statement (the “Statement”) they have issued 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)<sup>1</sup> supervised by the Agencies. The 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 these transactions receive enhanced scrutiny by the institution, and to ensure that the institution does not participate in illegal or inappropriate transactions. Comments regarding the Statement should be submitted to the Agencies on or before June 18, 2004. This memorandum summarizes the most significant provisions of the Statement.

**Background.** 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. The more complex variations of structured finance products, and the role played by financial institutions with respect to these products, 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. In particular, the OCC, the Federal Reserve and the SEC recently have taken strong and coordinated civil and enforcement actions against certain financial institutions that participated in complex structured finance transactions that appear to have been designed or used to shield the sponsor's true financial health from the public. In these enforcement actions, the regulators imposed significant financial penalties

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<sup>1</sup> 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 advisors 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.

upon the relevant financial institutions and required them to take several measures to strengthen their risk management practices for complex structured finance activities.<sup>2</sup>

The Statement confirms the Agencies' view that it is critical for financial institutions to have effective risk management and internal controls to ensure that the institutions' activities (particularly with respect to complex structured finance transactions) comply with the law and that all risks associated with a transaction are identified and appropriately addressed. Financial institutions should understand that the Statement imposes affirmative regulatory obligations in respect of verification of a customer's business objectives, financial disclosure and accounting treatment of transactions, particularly when designed primarily to achieve financial reporting or complex tax objectives. 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 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 most significant of these internal controls and procedures are summarized below.

### **Guidelines for Incorporating Structured Finance Transactions Into Existing Management Procedures, Controls and Systems**

As a general matter, the Statement indicates that financial institutions offering complex structured finance transactions should 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. The Statement is likely to affect only large financial institutions, which typically are the only institutions that offer these products. It will not apply to small institutions that do not offer these products. In any case, the recommended policies and procedures should be tailored by each affected institution to match the nature, scope and risk of its complex structured finance activities.

Importantly, the Statement does not define complex structured finance transactions, but instead gives non-exclusive characteristics of these transactions: First, complex structured finance transactions typically involve a non-standard product, structured to meet the specific financial objectives of a customer. They often involve professionals from multiple disciplines within the financial institution and may have significant fees or returns in relation to the risks of the transaction. They may involve special purpose entities. Most significantly, they expose the financial institution to elevated levels of market, credit, operational, legal or reputational risks. The burden is on the financial institution to determine the definition of complex structured finance transactions. Financial institutions should carefully assess the breadth of these characteristics, as many transactions may be encompassed within these characteristics.

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<sup>2</sup> Going forward, the SEC has provided the banking agencies with a memorandum (available at the Federal Reserve's website (SR Letter 04-7, May 14, 2004)) that describes the potential primary and secondary liability that a financial institution may have under the federal securities laws as a result of participating in complex structured finance activities. As examples, the SEC cites recent settlements that cost major financial institutions in the aggregate \$345 million in penalties to the SEC alone, not counting penalties paid to other agencies or settlements of nongovernmental civil actions.

**Role of Board and Management.** The Statement confirms that the board of directors of a financial institution (the “Board”) has ultimate responsibility for establishing the institution’s risk tolerances for complex structured finance transactions and ensuring that a sufficiently strong risk control framework is in place to guide the actions of the financial institution’s personnel. The Board should guide senior management in the implementation of 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.

The Statement notes that 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. 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 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 believe that such a senior-level committee can serve as an important part of an effective control infrastructure for complex structured finance activities.<sup>3</sup>

The Statement also provides that the Board and senior management 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. The Statement confirms the Agencies’ belief that 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.<sup>4</sup> Additionally, the Board and senior management should ensure that incentive plans are not structured in a way that encourages transactors to cross ethical boundaries when executing complex structured finance transactions.

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<sup>3</sup> Financial institutions should ensure that the control processes established for complex structured finance activities comply with any informational barriers established by the institution to manage potential conflicts of interest, insider trading or other concerns.

<sup>4</sup> The 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).

**Policies and Procedures.** Financial institutions offering complex structured finance transactions should 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. 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.

A financial institution should, at 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. The provisions of the Statement in respect of each of these items are summarized below.

**Transaction Approval.** The Statement provides that 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. The Statement notes that it is imperative that the approving authority 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 proper consideration of elements or factors that may expose the institution to higher levels of credit, market, operational, legal or reputational risk. The organization's policies also should clearly outline when third-party legal professionals should be engaged to review and opine on transactions, and when third-party accounting or tax professionals should be engaged to consult on transactions.

**New Product Policies.** The Statement advises that 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 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. In addition, the Statement notes the importance of an institution's policies requiring 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.

**Reputational and Legal Risk.** The Statement provides that the 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.

In this regard, as a regulatory matter the Statement imposes an affirmative obligation for financial institutions to ascertain a customer's business objectives for a transaction (or series of transactions). Presumably, this duty of investigation would extend to an entire transaction even when, for instance, a financial institution is participating in a limited part of the transaction. Additionally, the Statement imposes an obligation on a financial institution to evaluate the "appropriateness of the transaction." This may mean that the financial institution must evaluate the appropriateness of the transaction from both its perspective as well as the customer's perspective.

Policies should also ensure that the customer understands the risk and return profile of the transaction. In instances where the financial institution is designing the transaction and advising the customer, the disclosures to the customer should include an adequate description of the risks in the complex structured finance transaction as well as disclosure of any 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.

Policies should ensure that complex structured finance transactions are 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. 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.

The Statement warns that careful evaluations of the consequences of a transaction are particularly important when the transaction is designed to achieve a customer's financial reporting or complex tax objectives. Policies should clearly define the types of circumstances where the approval of transactions or patterns of transactions should be elevated to higher levels of financial institution management for reasons specific to legal or reputational risk.

The Statement provides that in creating procedures for elevating certain transactions to higher levels, financial institutions should identify the characteristics of those transactions, or series of transactions, that increase reputational and legal risk. Institutions should be conservative when 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 a level of review that is commensurate with the legal and reputational risks associated with the transaction. The Statement references a number of specific examples of characteristics that should be considered in determining whether or not a transaction or series of transactions might need additional scrutiny, including:

- Transactions with questionable economic substance or business purpose or designed primarily to exploit accounting, regulatory or tax guidelines) (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;
- Transactions with terms inconsistent with market norms (e.g., deep “in the money” options, non-standard settlement dates, non-standard forward-rate rolls);
- Transactions using non-standard legal agreements (e.g., customer insists on using its own documents that deviate from market norms);
- Transactions involving multiple obligors or otherwise lacking transparency (e.g. use of SPEs or limited partnerships);
- 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;
- 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;
- Transactions that cross multiple geographic or regulatory jurisdictions, making processing and oversight difficult;
- Transactions that cannot be processed via established operations systems; and
- Transactions with significant leverage.

The Statement further provides that having developed a process to identify transactions that may pose higher levels of legal and reputational risk, financial institutions should implement procedures to address these risks. These procedures should, among other things:

- 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 to the financial institution;
- Ensure 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 internal communication procedures to ensure that all financial institution personnel responsible for transaction approval and monitoring receive, and document in a timely manner, complete and accurate 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 time is allowed for a detailed, thorough review of the transaction by the relevant personnel;
- Ensure that complex structured finance transactions identified as having heightened risks receive a thorough review by senior management for an evaluation of credit, market, operational, legal and reputational risks to the financial institution;
- Ensure that complex structured finance transactions that are determined to present unacceptable risk to the financial institution are declined;
- Ensure that 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.

**Accounting and Disclosure by Customers.** As referenced above, the Statement notes that 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, the financial institution's procedures should ensure that staff approving the transactions 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.

The Statement provides that in any instance where the financial institution determines that a proposed transaction may 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. An important element of the Statement is the obligation it places on financial institutions to investigate a customer's accounting treatment, financial disclosures and objectives. This may include the hiring by a financial institution of third-party accounting professionals and direct contact with the customer's outside accountants. As part of the approval process, the Statement suggests that 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.

The Statement also provides that financial institutions 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 Statement advises that 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 a 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. The Statement further provides that financial institutions should maintain comprehensive documentation for all transactions approved. Financial institutions should understand that the documentation requirements extend to disapproved transactions as well. Specifically, the Statement mentions maintenance of documentation for disapproved transactions involving "controversial elements." Controversial elements could include transactions denied in the final stages of approval or due to customer requests for particular terms requiring additional scrutiny.

**Reporting.** The Statement notes that independent of the approval structure, the financial institution should define the complex structured finance transaction reporting requirements appropriate for various levels of management and the Board. Financial institutions should develop and ensure that reports summarizing pending and contemplated complex structured finance transactions are disseminated to appropriate levels of management for their review and further distribution. The Statement provides that at a minimum, the financial institution should establish an independent risk function that prepares a periodic summary of trends in complex structured finance transactions and a brief summary of each 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 Statement reflects the Agencies' view that the events of recent years evidence the need for a strong compliance function in those financial institutions engaged in complex structured finance transactions. The Statement instructs financial institutions to develop and enforce procedures to conduct periodic independent reviews of complex structured finance business activity to ensure 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.

**Audit.** The Statement confirms the Agencies' view that 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 highlighted by the Statement with respect to complex structured finance activities. The Statement notes that 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 Statement provides that 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.

The Statement advises that 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.

In addition, the Statement advises that given the complexity of the structured finance activities it may be desirable for financial institutions to retain outside consultants, accountants, or lawyers to review the structured product area. The Statement notes that the retention of such independent expertise may be a prudent method to fully grasp and control the overall risk resulting from such activities.

**Training.** The Statement describes appropriate training of personnel regarding 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 Statement further provides that the financial institution should retain documentation to support the initial and ongoing training of personnel involved in complex structured finance transactions.

**Conclusion.** The Agencies believe that financial institutions play a critical role in ensuring the integrity of financial markets, and that 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 Agencies expect financial institutions involved in structured finance transactions to build and implement enhanced risk management and internal controls systems that effectively ensure compliance with the law and control the risks associated with complex structured finance transactions. Perhaps the most significant question raised by the Statement is the extent to which it will be read by the public and the courts as creating new affirmative duties to third parties for financial institutions that engage in complex financial transactions.

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