SIDLEY AUSTIN LLP
SIDLEY

SIDLEY AUSTIN LLP
1501 K STREET, N.W.
WASHINGTON, D.C. 20005
(202) 736 8000
(202) 736 8711 FAX

dteitelbaum@sidley.com
202-736-8683

January 31, 2008

By Email

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, D.C. 20429

Re: Part 363 -- Annual Independent Audits and Reporting Requirements (RIN 3064-AD21)

Dear Mr. Feldman:

Sidley Austin LLP is a national law firm representing a variety of insured depository institutions. Some of those institutions have requested that we comment on their behalf on an important aspect of the Federal Deposit Insurance Corporation's ("FDIC") proposed rule on "Annual Independent Audits and Reporting Requirements"(the "Proposed Rule").

The Proposed Rule retains the existing requirement that management of insured depository institutions annually assess and report on their institution's compliance with designated safety and soundness laws and regulations. Annual Independent Audits and Reporting Requirements, Proposed Rule, 72 Fed. Reg. 62310 (Nov. 2, 2007). However, the Proposed Rule elaborates on this obligation, requiring: "The assessment must state management's conclusion as to whether the insured depository institution has complied with the designated safety and soundness laws and regulations during the fiscal year and disclose any noncompliance with these laws and regulations." *Id.* at 62323. In light of this proposed new requirement, the FDIC has requested comment on whether such management assessment should be made available for public inspection or designated as privileged and confidential. The FDIC should designate management's assessment as privileged, confidential and unavailable for public viewing, and the Proposed Rule should be expressly modified to provide this protection.

The purpose of the compliance self-assessment provision, like many provisions of the Sarbanes-Oxley Act, is not self-incrimination. Rather it is intended to focus management attention on ensuring compliance with certain key regulatory strictures and on facilitating dialogue between insured institutions and the Federal banking agencies regarding that compliance. These purposes would be substantially undercut by a requirement to make a public statement regarding non-compliance with key regulatory provisions such as insider lending and affiliate transaction requirements.

If communications with the Federal banking agencies regarding management's assessment of its own compliance record are to made available for public and media scrutiny, institutional diligence and candor would likely be replaced with highly structured internal investigations and bare-bones reporting. The compulsion to self-report violations of law in a public forum would mean institutions would have a strong incentive to manage their internal audits and compliance programs to a carefully scripted examination of specific requirements and to under-report if there is any arguable ambiguity regarding compliance. This incentive would cloud the internal audit and compliance program processes, as well as the institution-regulator relationship, all of which are relationships that thrive on transparency. The result would weaken the value of the very reports the FDIC seeks to promote. The heightened stakes with respect to self-reported noncompliance also would substantially increase compliance costs, as legal counsel would need to be intimately involved in each step of the compliance review in order ensure the production of a document that was carefully crafted for public consumption rather than regulatory review.

These negative incentives exist in part because public admission of violations of law would put insured institutions in legal jeopardy, as plaintiffs attorneys may then use such admissions against the interest of the reporting institutions. This risk is compounded by the fact that any report as to the legal conclusions reached by management of necessity entails some communication of the legal advice received from bank counsel, potentially creating issues as to and jeopardizing the privileged nature of those communications. Such a result would directly undercut the significant efforts recently made by the Federal banking agencies to preserve such privileges in connection with disclosures between insured institutions and their regulators.

Indeed, when the banking agencies sought an express privilege in the 2006 regulatory relief legislation to preserve the free flow of information between insured institutions and their regulators, several senior officials testified as to the need to protect those communications from public disclosure. For example, Donald Kohn, member of the Board of Governors of the Federal Reserve System, explained to the United States Senate Committee on Banking, Housing and Urban Affairs that the institution-regulator privilege is important to "facilitate the flow of information during the supervisory process by clarifying that depositor institutions and others do not waive any privilege they may have with respect to information when they provide the information to a Federal, State, or foreign banking authority as part of the supervisory process."[1] Similarly, Julie Williams, Chief Counsel for the Office of the Comptroller of the Currency, emphasized that institution-regulator privilege was needed during the examination process to "enhance the dialogue between banks and regulators [and] improve the supervisory process with added safety and soundness benefits."[2] Having fought for a privilege to preserve transparency in the institution-regulator dialogue, it would be anomalous to now gut significant aspects of that privilege by requiring publication of communications of highly sensitive compliance information.

Similarly, the requirement to make management's conclusions regarding compliance public would have the additional unintended consequence of breaching the confidentiality of communications by the agencies themselves. For example, if an "apparent violation" of law is identified by a federal bank examiner as part of the ordinary course of a bank examination, the communication of that conclusion, including in the institution's written examination report, currently is privileged and may not be publicly revealed. Having received such a communication, however, management would be hard-pressed not to echo the examiner's conclusions in the audit certification, effectively compelling public disclosure in violation of that long-standing protection of examination findings. The federal bank regulatory proscription against publishing or disclosing the contents of exam reports is well-established and thoroughly grounded in the public policies that encourage full and open discourse between regulators and their regulated institutions in order to build a stronger and better managed institutions. The FDIC should not undercut those policies through a public disclosure requirement in the context of the audit process.

Finally, the FDIC should not underestimate that public relations damage that can be done by inappropriate release of technical compliance conclusions related to sensitive issues like affiliate transactions and insider lending. Compliance judgments regarding such matters often involve complex issues of regulatory policy and arcane and highly technical interpretive topics. Whereas a financial institution regulator can understand and place those matters in the context of an institution's overall compliance record, the same information easily may be incorrectly understood by the public and media. If self-reported institutional non-compliance is publicly disclosed, there is a substantial risk that such information could be used inaccurately and unfairly to tarnish the reputation of even the most compliance-minded institutions.

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[1] *Consideration of Regulatory Relief Proposals: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 109-993 (2006) (prepared statement of Donald L. Kohn, Member of the Board of Governors of the Federal Reserve System).

[2] *Consideration of Regulatory Relief Proposals: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 109-993 (2006) (prepared statement of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel for the Office of the Comptroller of the Currency).

Accordingly, we strongly encourage the FDIC to avoid creating significant legal and reputational risks and costs for insured depository institutions and to preserve the free flow of information between insured institutions and their regulators by maintaining the confidentiality of management's assessment of compliance under the Proposed Rule.

We appreciate this opportunity to comment on the Proposed Rule. If you have any questions, please contact me directly.

Sincerely,

David Teitelbaum