

**MEMORANDUM TO:** The Board of Directors

**FROM:** Sandra L. Thompson, Acting Director  
Division of Supervision and Consumer Protection

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

**Proposal:** That the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) approve the publication of the attached *Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities* (Statement) in the Federal Register for a 30-day comment period. The Statement will be issued on an interagency basis by FDIC, FRB, OCC, OTS, and SEC (collectively the “Agencies”).

This Statement focuses in particular on those complex structured finance transactions designed to achieve the specific legal, tax or accounting objectives of a particular customer in a novel or complex manner, that often elevate an institution’s exposure to various forms of legal or reputational risk (“elevated risk CSFTs”). The Statement is not intended to cover products with well-established track records that are familiar to participants in the financial markets, including standard public mortgage-backed securities transactions, public securitizations of retail credit cards, asset-backed commercial paper conduit transactions, and hedging transactions involving “plain vanilla” derivatives and collateralized loan obligations.

The Statement describes the types of internal controls and risk management policies and procedures that the Agencies have found to be useful in assisting financial institutions in identifying, managing and addressing effectively the potentially heightened legal or reputational risks that may arise from certain complex structured finance transactions and the risks associated with complex structured financing activity.

**Recommendation:** That the Board approve publication of the Statement for a 30-day public comment period.

Concur:

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Douglas H. Jones  
Acting General Counsel

## **BACKGROUND**

On May 14, 2004 the FDIC, in conjunction with the other Agencies, issued the “Interagency Statement on Sound Practices Concerning Structured Finance Activities” for public comment. The Statement was created, in part, as a response to Congressional hearings and testimonies regarding the failure of Enron and the extent to which banking entities assisted in concealing Enron’s true financial condition by arranging complex structured finance transactions.

It became apparent that financial intermediaries needed to establish better processes for the review and consideration of any complex structured finance transaction (CSFT), either entered into for the benefit of the institution or arranged for its customers, where the purpose is to circumvent regulatory or financial reporting requirements, evade tax liabilities, or other illegal or improper behavior, as such transactions often expose institutions to greater legal or reputational risks.

The FDIC received 17 comment letters that were generally supportive of the Statement. However, many of the respondents believed the Statement was overly broad and punitive, and lacked the focus needed to target those transactions that were of most concern to the regulators. In response to commenters’ concerns, the Agencies have, among other things:

- Focused the statement more clearly on those CSFTs that may present heightened legal or reputational risks to a participating institution;
- Clarified that the statement does not apply to structured finance transactions, such as standard public mortgage-backed securities transactions, that are familiar to participants in the financial markets and have well-established track records and, for this reason, will not affect or apply to the vast majority of small financial institutions;
- Modified the examples of CSFTs that may warrant additional scrutiny by an institution to focus on transactions that are more likely to present elevated levels of legal or reputational risk to an institution (e.g., transactions that raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading);

- Clarified that the due diligence conducted by a financial institution for an elevated risk CSFT should focus on those issues identified by the institution as potentially creating heightened levels of legal or reputational risk for the institution;
- Recognized that the role a financial institution plays in a CSFT may affect both the amount of information it has concerning the transaction and the level of legal or reputational risks presented by the transaction to the institution;
- Streamlined and modified the documentation and general control portions of the statement to focus on the proper goals of an institution's policies and procedures in these areas; and
- Provided that a financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations and standards of those foreign jurisdictions.

The Agencies acknowledge that the continued development of complex products may result in policies and procedures for credit systems that continuously need to be fine tuned. However, the Agencies believe that this Statement provides a framework that is consistent with the goal of having participant financial institutions aware of the potential legal, regulatory and reputational risks associated with these transactions and establishing internal policies and procedural guidelines for identifying, managing and addressing these heightened risks.

Given the passage of time between the issuance of the Statement for public comment on May 14, 2004 and the issuance of the current draft, the Agencies believe that it is appropriate to provide the industry with an additional opportunity to comment. Therefore, the Agencies are proposing to publish this Statement in the Federal Register for a 30-day comment period.

## **RESOLUTION**

**WHEREAS**, over the last several years financial markets have grown dramatically 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; and

**WHEREAS**, financial institutions have played an important role in the development of complex structured finance products and their markets; and

**WHEREAS**, recently, a number of structured finance transactions appear to have been used to alter the appearance of or misrepresent certain business organizations' financial statements, or have been structured with the purpose of evading the payment of taxes; and

**WHEREAS**, a financial institution may assume significant reputational and legal risk if it engages in a complex structured finance transaction with a customer that uses the transaction to circumvent financial reporting requirements, evade the payment of taxes or for other illegal behavior; and

**WHEREAS**, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission ("Agencies") have recognized the foregoing and have concerns regarding the impact complex structured finance transactions may have on individual banking organizations and the overall impact on the banking industry; and

**WHEREAS**, the Agencies have consulted and coordinated with one another to jointly produce Interagency Guidance on Sound Practices Concerning Complex Finance Activities ("Statement") which the FDIC published in the *Federal Register* on May 19, 2004, to seek industry and public comment on all aspects of the guidance; and

**WHEREAS**, the staff has fully considered the comments received and has recommended that the FDIC Board of Directors of the Corporation ("Board") authorize the attached revised joint Statement for publication in the *Federal Register*;

**NOW, THEREFORE, BE IT RESOLVED,** that the Board hereby determines that it is appropriate to issue the attached proposed Statement and further authorizes the Executive Secretary, or his designee, to cause the attached joint Statement to be published in the *Federal Register* for an additional 30-day comment period jointly with the other Agencies, in a form and manner acceptable to the Executive Secretary, or his designee, and the General Counsel, or his designee.

**BE IT FURTHER RESOLVED,** that the Board hereby delegates authority to the Executive Secretary [or his designee] and the General Counsel [or his designee] to make technical, nonsubstantive, or conforming changes to the attached Federal Register notice and to take such other actions and issue such other documents incident and related to the foregoing as they deem necessary or appropriate to fulfill the Board's objective in connection with this matter.

**DEPARTMENT OF THE TREASURY**

**Office of the Comptroller of the Currency**

**[Docket No. 06-XX]**

**Office of Thrift Supervision**

**[No. 2006-]**

**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  
Elevated Risk 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) (collectively, the Agencies).

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

**SUMMARY:** On May 19, 2004, the Agencies issued and requested comment on a proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities (“Initial Statement”) of national banks, state banks, bank holding companies, federal and state savings associations, savings and loan holding companies, U.S. branches and agencies of foreign banks, and SEC registered broker-dealers and investment advisers (collectively, “financial institutions” or “institutions”). The Initial Statement described some of the internal controls and risk management procedures that may help financial institutions identify, manage, and address the heightened reputational and legal risks that may arise from certain complex structured finance transactions (“CSFTs”). After reviewing the comments received on the Initial Statement, the Agencies are requesting comment on a revised proposed interagency statement (“Revised Statement”). The Revised Statement has been modified in numerous respects to address issues and concerns raised by commenters, clarify the purpose, scope and effect of the statement, and make the statement more principles-based. These changes include reorganizing and streamlining the document to reduce redundancies and to focus the statement on those CSFTs that may pose heightened levels of legal or reputational risk to the relevant institution (referred to as “elevated risk CSFTs”). In addition, the Agencies have modified the examples of transactions that may present elevated risk to make these examples more risk-focused, and have recognized more explicitly that an institution’s review and approval process for elevated risk CSFTs should be commensurate with, and focus on, the potential risks presented by the transaction to the institution. As discussed below, the Revised Statement will not affect or apply to the vast majority of small financial institutions, nor does it create any private rights of action.

**DATES:** Comments on the Revised Statement should be received on or before [INSERT DATE 30 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

## **ADDRESSES:**

OCC: You should include OCC and Docket Number 06-\_\_\_ in your comment.

You may submit comments by any of the following methods:

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

- OCC Web site: <http://www.occ.treas.gov>. Click on "Contact the OCC," scroll down and click on "Comments on Proposed Regulations."

- E-mail address: [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

- Fax: (202) 874-4448.

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

- Hand Delivery/Courier: 250 E Street, SW., Attn: Public Information Room, Mail Stop 1-5, Washington, DC 20219.

Instructions: All submissions received must include the agency name (OCC) and docket number or Regulatory Information Number (RIN) for this notice of proposed rulemaking. In general, OCC will enter all comments received into the docket without change, including any business or personal information that you provide.

You may review comments and other related materials by any of the following methods:

- Viewing Comments Personally: You may personally inspect and photocopy comments at the OCC's Public Information 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 e-mail or CD-ROM copies of

comments that the OCC has received by contacting the OCC's Public Information Room at: [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

- Docket: You may also request available background documents and project summaries using the methods described above.

OTS: You may submit comments, identified by No. 2006- 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](mailto:regs.comments@ots.treas.gov). Please include No. 2006- 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, D.C. 20552, Attention: No. 2006-.
- Hand Delivery/Courier: Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9:00 a.m. to 4:00 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office, Attention: No. 2006-.

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](mailto: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 10:00 a.m. and 4:00 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](mailto: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, 20<sup>th</sup> Street and Constitution Avenue, NW., Washington, D.C. 20551.

All public comments are available from the Board's Web site at [www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm](http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm) as submitted, unless modified, 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 20<sup>th</sup> Streets, NW.) between 9:00 a.m. and 5:00 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, D.C. 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](mailto:comments@fdic.gov)). Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, NW., Washington, D.C., between 9:00 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/\[INSERT\].shtml](http://www.sec.gov/rules/policy/[INSERT].shtml)); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number **XX** on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number **[XX]**. 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/\[INSERT\].shtml](http://www.sec.gov/rules/policy/[INSERT].shtml)). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, 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, Risk Evaluation, (202) 874-4660; Grace E. Dailey, Deputy Comptroller, Large Bank Supervision, (202) 874-4610; or Ellen Broadman, Director, Securities and Corporate Practices Division, (202) 874-5210, Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, DC 20219.

OTS: Fred J. Phillips-Patrick, Director, Credit Policy, Examinations and Supervision Policy, (202) 906-7295; Deborah S. Merkle, Project Manager, Credit Policy, Examinations and Supervision Policy, (202) 906-5688; or David A. Permut, Senior Attorney, Business Transactions Division, (202) 906-7505, Office of Thrift Supervision, 1700 G Street, N.W., Washington, DC 20552.

Board: Sabeth I. Siddique, Assistant Director, (202) 452-3861, Virginia Gibbs, Senior Supervisory Financial Analyst, (202) 452-2521, Division of Banking Supervision and Regulation; or Kieran J. Fallon, Assistant General Counsel, (202) 452-5270, Anne B. Zorc, Attorney, (202) 452-3876, Legal Division, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. Users of Telecommunication Device for Deaf (TTD) only, call (202) 263-4869.

FDIC: Jason C. Cave, Associate Director, (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, N.W., Washington, DC 20429.

SEC: Mary Ann Gadziala, Associate Director, Office of Compliance Inspections and Examinations, (202) 551-6207; Catherine McGuire, Chief Counsel, Linda Stamp Sundberg, Senior Special Counsel (Banking and Derivatives), or Randall W. Roy, Branch Chief, Division of Market Regulation, (202) 551-5550, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549.

## **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 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 assets, and other types of structured finance transactions serve important purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. As a result, structured finance transactions, including the more complex variations of these transactions, now are an essential part of U.S. and international capital markets.

When a financial institution participates in a CSFT, it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, a financial institution involved in a CSFT may face heightened risk if the customer's regulatory, tax or accounting treatment for the CSFT, or disclosures concerning the CSFT in its public filings or financial statements, do not comply with applicable laws, regulations or accounting principles.

In some cases, certain CSFTs appear to have been used in illegal schemes that misrepresented the financial condition of public companies to investors and regulatory authorities. Those cases highlight the substantial legal and reputational risks that financial institutions may face when they participate in a CSFT that is used by the institution's customer to circumvent regulatory or financial reporting requirements or further other illegal behavior.<sup>1</sup> 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 engaged in CSFTs that appeared to have been designed or used to shield their customers' true financial health from the public. These actions involved significant financial penalties on the institutions and required the institutions to take several measures to strengthen their risk management procedures for CSFTs.<sup>2</sup> The complex structured finance relationships involving these financial institutions also sparked an investigation by the Permanent Subcommittee on

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<sup>1</sup> For a memorandum on the potential liability of a financial institution for securities laws violations arising from participation in a CSFT, 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/srletters/2004/> and [www.occ.treas.gov](http://www.occ.treas.gov)).

<sup>2</sup> See, e.g. In the Matter of Citigroup, Inc., Securities 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 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 v. J.P. Morgan Chase, 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.).

Governmental Affairs of the United States Senate,<sup>3</sup> as well as numerous lawsuits by private litigants.

Following these investigations, the OCC, Board and SEC also conducted special reviews of several large banking and securities firms that are significant participants in the market for CSFTs. These reviews were designed to evaluate the new 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 CSFTs. These assessments indicated that many of the large financial institutions engaged in CSFTs already had taken meaningful steps to improve their control infrastructure relating to CSFTs. The Agencies also focused attention on the complex structured finance activities of financial institutions in the normal course of the supervisory process.

## **II. Initial Statement**

To further assist financial institutions in identifying, managing, and addressing the risks that may be associated with CSFTs, the Agencies developed and requested public comment on the Initial Statement.<sup>4</sup> As a general matter, the Initial Statement provided that financial institutions engaged in CSFTs should have and maintain a comprehensive set of formal, firm-wide policies and procedures that are designed to allow the institution to identify, document, evaluate, and control the full range of credit, market, operational, legal, and reputational risks that may arise from CSFTs. The Initial Statement also described the types of policies and procedures that financial institutions should have for CSFTs in the following specific areas: (1)

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

<sup>4</sup> See 69 FR 28,980, May 19, 2004.

transaction approval; (2) approval of new complex structured finance products; (3) identification and management of the potential reputational and legal risk associated with CSFTs; (4) review of the customer's proposed accounting and disclosures for CSFTs; (5) documentation of CSFTs; (6) management reporting for CSFTs; (7) independent monitoring and analysis of the institution's compliance with its internal policies regarding CSFTs; (8) role of internal audit; and (9) training of personnel involved in CSFTs.

Among other things, the Initial Statement provided that financial institutions should establish a clear process for identifying those CSFTs that may create heightened legal or reputational risk for the institution, and included a list of transaction characteristics that may indicate that a CSFT (or series of CSFTs) creates elevated levels of legal or reputational risk for the institution. The Initial Statement also provided that an institution should ensure that transactions identified as being elevated risk CSFTs are thoroughly reviewed by the institution's control functions and management during the institution's transaction or new product approval processes. As part of this review, the Initial Statement indicated that the institution should obtain and document complete and accurate information about the customer's business objectives for entering into the transaction, as well as about the customer's proposed accounting treatment and financial disclosures relating to the transaction.

### **III. Overview of Comments**

The Agencies collectively received comments on the Initial Statement from more than 40 persons, although many commenters submitted multiple comments or submitted identical comments to multiple Agencies. Commenters included banking organizations, trade associations, investment banks, consulting firms, public accounting firms, law firms, an

association of state officials, and individuals. In addition to submitting written comments, some commenters also met with Agency representatives to discuss their views of the Initial Statement.

Commenters generally supported the Agencies' efforts to describe the types of risk management procedures and internal controls that may help financial institutions identify and mitigate the legal and reputational risks associated with CSFTs. In this regard, many commenters recognized that financial institutions need a robust risk management and control framework to help institutions avoid becoming involved in CSFTs that are used for illegal or abusive purposes and to manage the risks associated with CSFTs.

Virtually all of the commenters, however, recommended changes to the Initial Statement. For example, many commenters argued that the characteristics of CSFTs in general and of elevated risk CSFTs in particular identified in the Initial Statement were too broad and would encompass many structured finance products that are not novel or complex and that do not present heightened legal or reputational risks for participating financial institutions. These commenters argued, for example, that the Initial Statement could be read as requiring financial institutions to identify any structured finance transaction that involves a special purpose entity ("SPE") or cross-border elements as an elevated risk CSFT.

Many commenters also asserted that the internal controls and risk management processes described in the Initial Statement for CSFTs and elevated risk CSFTs were overly prescriptive and burdensome. For example, many commenters expressed concern that the Initial Statement could be read as requiring a financial institution to conduct a detailed and extensive pre-transaction review of all CSFTs regardless of the role that the institution played in the transaction, and regardless of whether the transaction's characteristics suggested that it may create significant legal, reputational or other risks for the institution. Similarly, many

commenters argued that the Initial Statement imposed new and inappropriate obligations on financial institutions to confirm the validity of a customer's financial disclosures or accounting or tax treatment for a CSFT, and would establish new and extensive documentation requirements for CSFTs.

Commenters asserted that, in light of these and other concerns, the Initial Statement had the potential to increase the legal risks faced by financial institutions participating in CSFTs. In addition, commenters argued that the Initial Statement, if implemented, would disrupt the market for legitimate structured finance products and place U.S. financial institutions at a competitive disadvantage in the market for CSFTs both in the United States and abroad.

As a general matter, commenters recommended that the Agencies modify the Initial Statement to make it more principles-based and focused on transactions that may create elevated risks for a participating financial institution. For example, many commenters recommended that the Agencies modify the list of characteristics of elevated risk CSFTs to focus on factors that are likely indicators that a transaction may, in fact, create heightened legal or reputational risks for a participating institution. In addition, commenters recommended that the Agencies provide financial institutions greater flexibility to design internal controls and risk management procedures for CSFTs that are tailored to the size, activities and general internal control framework of the institution. Finally, many commenters recommended that the Agencies republish any revised statement for a new round of public comment.

#### **IV. Overview of Revised Statement**

The Agencies have substantially revised the Initial Statement in light of the comments. In particular, the Revised Statement has been shortened and reorganized to be more principles-based and to focus on elevated risk CSFTs. Because these revisions are substantial,

and the Revised Statement is an important explanation of the key principles and best practices governing CSFT activities, the Agencies invite public comment on the Revised Statement.

The Agencies continue to believe that it is important for financial institutions engaged in CSFTs to have policies and procedures that are designed to allow the institution to effectively manage and address the risks associated with their CSFT activities. These policies and procedures should, among other things, be designed to allow the institution to identify during its transaction and new product approval processes those CSFTs that may present elevated legal or reputational risks to the institution. In addition, an institution's policies and procedures should provide that CSFTs identified as potentially having elevated legal or reputational risks are reviewed by appropriate levels of control and management personnel at the institution, including personnel from control areas that are independent of the business line(s) involved in the transaction. The level and amount of due diligence conducted by an institution for an elevated risk CSFT should be commensurate with the transaction's potential risk to the institution. In conducting this due diligence, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal or other professionals.

If, after evaluating an elevated risk CSFT, a financial institution determines that its participation in the CSFT would create significant legal or reputational risks for the institution, the financial institution should take appropriate steps to manage and address these risks. Such steps may include modifying the transaction or conditioning its participation in the transaction upon the receipt of representations or assurances from the customer that reasonably address the heightened risks presented by the transaction. A financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking

appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risks to the institution or would result in a violation of applicable law, regulation or accounting principles.

With these broad principles in mind, the Agencies have made a number of changes to the Initial Statement to address the issues and concerns raised by commenters, to clarify the purpose, scope and effect of the Revised Statement, and to make the document more risk-focused. The Agencies believe that, with these changes, the Revised Statement promotes sound risk management principles while providing individual financial institutions greater flexibility to develop implementing policies, procedures and systems that are appropriately tailored to the nature, scope, complexity and risks of its CSFT activities and to the institution's general internal control framework. In particular, the Agencies have, among other things:

- Focused the statement more clearly on those CSFTs that may present heightened legal or reputational risks to a participating institution;
- Clarified that the statement does not apply to structured finance transactions, such as standard public mortgage-backed securities transactions, that are familiar to participants in the financial markets and have well-established track records and, for this reason, will not affect or apply to the vast majority of small financial institutions;
- Modified the examples of CSFTs that may warrant additional scrutiny by an institution to focus on transactions that are more likely to present elevated levels of legal or reputational risk to an institution (e.g., transactions that raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading);
- Clarified that the due diligence conducted by a financial institution for an elevated

risk CSFT should focus on those issues identified by the institution as potentially creating heightened levels of legal or reputational risk for the institution;

- Recognized that the role a financial institution plays in a CSFT may affect both the amount of information it has concerning the transaction and the level of legal or reputational risks presented by the transaction to the institution;

- Streamlined and modified the documentation and general control portions of the statement to focus on the proper goals of an institution's policies and procedures in these areas; and

- Provided that a financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations and standards of those foreign jurisdictions.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, the Revised Statement continues to draw heavily on controls and procedures that the Agencies previously have found to be effective in assisting a financial institution to manage and control risks and identifies ways in which these controls and procedures can be applied effectively to elevated risk CSFTs. Moreover, as noted above, many of the large financial institutions that are actively involved in CSFT-related activities have taken steps in recent years to bolster and improve their risk management and internal control processes for CSFTs. Based on the Agencies' supervisory experience, the Agencies believe that the Revised Statement generally is consistent with the controls and processes used by large financial institutions to manage the risks arising from their CSFT activities.

The Agencies propose to adopt the Revised Statement as supervisory guidance (in the case of the Federal banking agencies) or a policy statement (in the case of the SEC) and to

use the Revised Statement in reviewing the internal controls and risk management systems of those financial institutions that are engaged in CSFTs as part of the Agencies' supervisory processes. Accordingly, the Revised Statement does not create any private rights of action, nor does it 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. The Agencies have added a statement to this effect in the Revised Statement.

The Agencies request comment on all aspects of the Revised Statement.

## **V. Paperwork Reduction Act**

The Agencies have determined that certain provisions of the Revised Statement contain collection of information requirements as defined in the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 et seq.) (PRA). An Agency may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number.

OMB has reviewed and approved the proposed information collections for the FDIC, OTS, and OCC; the SEC is submitting their proposed information collection to OMB for review and approval; and the Board has reviewed the Revised Statement under the authority delegated to the Board by OMB (5 CFR 1320, appendix A.1).

### OMB control numbers:

OCC: 1557-0229

OTS: 1550-0111

FRB: 7100-0xxx

FDIC: 3064-0148

SEC: 3235-0xxx

Comment was requested on the proposed information collections contained in the Initial Statement published for comment on May 19, 2004. As discussed above, many commenters asserted that the Initial Statement in general, and its documentation provisions in particular, were unduly burdensome and prescriptive. For this reason, some commenters asserted that the estimates of the burden (100 hours per respondent) were too low.

In light of this and the modifications made to the Initial Statement, the Agencies have reconsidered the burden estimates previously published and are once again requesting comment before finalizing this statement. In response to the comments, the Agencies have made significant modifications to make the Revised Statement more principles-based and risk-focused than the Initial Statement, and to provide individual institutions greater flexibility in developing policies, procedures, and systems that are appropriate and tailored to the nature of the institution's CSFT activities and general internal control framework. The Agencies believe that the information collection requirements contained in the Revised Statement, as discussed earlier in the notice, are generally consistent with the types of policies and procedures that the large financial institutions actively involved in CSFTs have already developed and implemented as a matter of usual and customary business practices. Therefore, the information collections contained in the Revised Statement are significantly less burdensome than those estimated in the Initial Statement and, thus, the Agencies have revised the hourly estimate down from 100 hours per response to an average of 25 hours per response.

**New Estimates:**

**OCC**

Number of Respondents: 21

Estimated Time per Response: 25 hours

Total Estimated Annual Burden = 525 hours

**OTS**

Number of Respondents: 5

Estimated Time per Response: 25 hours

Total Estimated Annual Burden = 125 hours

**Board**

Number of Respondents: 20

Estimated Time per Response: 25 hours

Total Estimated Annual Burden = 500 hours

**FDIC**

Number of Respondents: 5

Estimated Time per Response: 25 hours

Total Estimated Annual Burden = 125 hours

**SEC**

Number of Respondents: 5

Estimated Time per Response: 25 hours

Total Estimated Annual Burden = 125 hours

Comments continue to be invited on:

(a) Whether the collections of information contained in the Revised Statement are necessary for the proper performance of the Agencies' functions, including whether the information has practical utility;

(b) The accuracy of the estimates of the burden of the information collection, including the validity of the methodology and assumptions used;

- (c) Ways to enhance the quality, utility, and clarity of the information to be collected;
- (d) Ways to minimize the burden of the information collection on respondents, including through the use of automated collection techniques or other forms of information technology; and
- (e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

Comments on the information collections contained in the Revised Statement should be addressed to:

OCC: You should direct your comments to:

Communications Division, Office of the Comptroller of the Currency, Public Information Room, Mailstop 1-5, Attention: 1557-0229, 250 E Street, SW, Washington, DC 20219. In addition, comments may be sent by fax to (202) 874-4448, or by electronic mail to [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov). You can inspect and photocopy the comments at the OCC's Public Information Room, 250 E Street, SW, Washington, DC 20219. You can make an appointment to inspect the comments by calling (202) 874-5043.

Additionally, you should send a copy of your comments to OCC Desk Officer, 1557-0229, by mail to U.S. Office of Management and Budget, 725, 17th Street, NW, #10235, Washington, DC 20503, or by fax to (202) 395-6974.

You can request additional information or a copy of the collection from Mary Gottlieb, OCC Clearance Officer, or Camille Dickerson, (202) 874-5090, Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

OTS: 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](mailto:infocollection.comments@ots.treas.gov). OTS will post comments and the related index on the OTS internet site at [www.ots.treas.gov](http://www.ots.treas.gov). In addition, interested persons may inspect the 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 [public.info@ots.treas.gov](mailto:public.info@ots.treas.gov), or send a facsimile transmission to (202) 906-7755.

To obtain a copy of the submission to OMB, contact Marilyn K. Burton at [marilyn.burton@ots.treas.gov](mailto:marilyn.burton@ots.treas.gov), (202) 906-6467, or fax number (202) 906-6518, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

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

- Agency 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](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.
- FAX: 202/452-3819 or 202/452-3102.
- Mail: Michelle Long, Federal Reserve Board Clearance Officer (202-452-3829), Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, DC 20551. Telecommunications Device for the Deaf (TDD) users may contact (202-263-4869), Board of Governors of the Federal Reserve System, Washington, DC 20551.

All public comments are available from the Board's Web site at [www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm](http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm) as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

**FDIC:** Interested parties are invited to submit written comments to the FDIC concerning the Paperwork Reduction Act implications of this proposal. Such comments should refer to "Complex Structured Financial Transactions, 3064-0148." Comments may be submitted by any of the following methods:

- <http://www.FDIC.gov/regulations/laws/federal/propose.html>
- E-mail: [comments@FDIC.gov](mailto:comments@FDIC.gov). Include "Complex Structured Financial Transactions, 3064-0148" in the subject line of the message
- Mail: Steven F. Hanft (202-898-3907), Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, DC 20429.
- Hand Delivery: 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.

**SEC:** You should direct your comments to:

Office of Management and Budget, Attention Desk Officer of the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, with a copy sent to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090 with reference to File No. S7-22-04.

The proposed Revised Statement follows:

## **INTERAGENCY STATEMENT ON SOUND PRACTICES CONCERNING ELEVATED RISK 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 assets and other types of structured finance transactions serve important business purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. As a result, structured finance transactions now are an essential part of U.S. and international capital markets. Financial institutions have played and continue to play an active and important role in the development of structured finance products and markets, including the market for the more complex variations of structured finance products.

When a financial institution participates in a complex structured finance transaction (“CSFT”), it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, in some circumstances, a financial institution may face heightened legal or reputational risk if a customer’s regulatory, tax or accounting treatment for a CSFT, or disclosures concerning the CSFT in its public filings or financial statements, do not comply with applicable laws, regulations or accounting principles. Indeed, some financial institutions have incurred significant legal costs and liability and suffered

reputational harm due to their role in certain transactions that were used by customers to misrepresent the customers' financial condition to investors, regulatory authorities or others. Reputational risk poses a significant threat to financial institutions because the nature of their business requires them to maintain the confidence of customers, creditors and the general marketplace.

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 (the regulatory agencies) have long expected financial institutions to develop and maintain robust control infrastructures that enable them to identify, evaluate and address the risks associated with their business activities.

Financial institutions also must conduct their activities in accordance with applicable statutes and regulations.

## **II. SCOPE AND PURPOSE OF STATEMENT**

The regulatory agencies are issuing this Statement to describe the types of risk management principles that we believe may help a financial institution to identify CSFTs that may pose heightened legal or reputational risks to the institution (“elevated risk CSFTs”) and to evaluate, manage and address these risks within the institution’s internal control framework.<sup>5</sup>

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<sup>5</sup> As used in this Statement, the term “financial institution” or “institution” refers to 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 (other than foreign banking organizations) 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 Office of the Comptroller, the Federal Reserve Board and the Federal Deposit Insurance Corporation also are considered to be financial institutions for purposes of this Statement.

Structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities transactions, public securitizations of retail credit cards, asset-backed commercial paper conduit transactions, and hedging-type transactions involving “plain vanilla” derivatives and collateralized loan obligations, are familiar to participants in the financial markets, and these vehicles have a well-established track record. These transactions typically would not be considered CSFTs for the purpose of this Statement.

Because this Statement focuses on sound practices related to CSFTs that may create heightened legal or reputational risks – transactions that typically are conducted by a limited number of large financial institutions – it will not affect or apply to the vast majority of financial institutions, including most small institutions. As in all cases, a financial institution should tailor its internal controls so that they are appropriate in light of the nature, scope, complexity and risks of its activities. Thus, for example, an institution that is actively involved in structuring and offering CSFTs that may create heightened legal or reputational risk for the institution should have a more formalized and detailed control framework than an institution that participates in these types of transactions less frequently. The internal controls and procedures discussed in this Statement are not all inclusive, and, in appropriate circumstances, an institution may find that other controls, policies, or procedures are appropriate in light of its particular CSFT activities.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this Statement draws heavily on controls and procedures that the agencies previously have found to be effective in assisting a financial institution to manage and control risks and identifies ways in which these controls and

procedures can be effectively applied to elevated risk CSFTs. Although this Statement highlights some of the most significant risks associated with elevated risk CSFTs, it is not intended to present a full exposition of all risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory guidance prepared by the agencies for further information concerning market, credit, operational, legal and reputational risks as well as internal audit and other appropriate internal controls.

This Statement 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. At the same time, adherence to the principles discussed in this Statement would not necessarily insulate a financial institution from regulatory action or any liability the institution may have to third parties under applicable law.

### **III. IDENTIFICATION AND REVIEW OF ELEVATED RISK COMPLEX STRUCTURED FINANCE TRANSACTIONS**

A financial institution that engages in CSFTs should maintain a set of formal, firm-wide policies and procedures that are designed to allow the institution to identify, evaluate, assess, document, and control the full range of credit, market, operational, legal and reputational risks associated with these transactions. These policies may be developed specifically for CSFTs, or included in the set of broader policies governing the institution generally. A financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate in order to account for, and comply with, the applicable laws, regulations and standards of those jurisdictions.<sup>6</sup>

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<sup>6</sup> In the case of U.S. branches and agencies of foreign banks, the institution should coordinate these policies with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor. In addition, the U.S. branches and agencies

A financial institution's policies and procedures should establish a clear framework for the review and approval of individual CSFTs. These policies and procedures should set forth the responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of CSFTs. Financial institutions may find it helpful to incorporate the review of new CSFTs into their existing new product policies. In this regard, a financial institution should define what constitutes a "new" complex structured finance product and establish a control process for the approval of such new products. In determining whether a CSFT is "new," a financial institution may consider a variety of factors, including whether it contains structural or pricing variations from existing products, whether the product is targeted at a new class of customers, whether it is designed to address a new need of customers, whether it raises significant new legal, compliance or regulatory issues, and whether it or the manner in which it would be offered would materially deviate from standard market practices. An institution's policies should require new complex structured finance products to receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

#### **A. Identifying Elevated Risk CSFTs**

As part of its transaction and new product approval controls, a financial institution should establish and maintain policies, procedures and systems to identify elevated risk CSFTs. Because of the potential risks they present to the institution, transactions or new products identified as elevated risk CSFTs should be subject to heightened reviews during the institution's transaction or new product approval processes. Examples of transactions that an institution may

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of foreign banks should implement a control infrastructure for CSFTs, including management, review and approval requirements, that is consistent with the institution's overall corporate and management structure as well as its framework for risk management and internal controls.

determine warrant this additional scrutiny are those that (either individually or collectively) appear to the institution during the ordinary course of its transaction approval or new product approval process to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period for the customer;
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;
- Involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- Involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;<sup>7</sup>
- Have material economic terms that are inconsistent with market norms (e.g., deep "in the money" options or historic rate rollovers); or
- Provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market or operational risk assumed by the institution.

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<sup>7</sup> This item is not intended to include traditional, non-binding "comfort" letters or assurances 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's subsidiary) is an integral and important part of the parent's operations.

The examples listed previously are provided for illustrative purposes only, and the policies and procedures established by financial institutions may differ in how they seek to identify elevated risk CSFTs. The goal of each institution's policies and procedures, however, should remain the same – to identify those CSFTs that warrant additional scrutiny in the transaction or new product approval process due to concerns regarding legal or reputational risks.

Financial institutions that structure or market, act as an advisor to a customer regarding, or otherwise play a substantial role in a transaction may have more information concerning the customer's business purpose for the transaction and any special accounting, tax or financial disclosure issues raised by the transaction than institutions that play a more limited role. Thus, the ability of a financial institution to identify the risks associated with an elevated risk CSFT may differ depending on its role.

#### **B. Due Diligence, Approval and Documentation Process for Elevated Risk CSFTs**

Having developed a process to identify elevated risk CSFTs, a financial institution should implement policies and procedures to conduct a heightened level of due diligence for these transactions. The financial institution should design these policies and procedures to allow personnel at an appropriate level to understand and evaluate the potential legal or reputational risks presented by the transaction to the institution and to manage and address any heightened legal or reputational risks ultimately found to exist with the transaction.

Due Diligence. If a CSFT is identified as an elevated risk CSFT, the institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction with a particular focus on those issues identified as potentially creating heightened levels of legal or reputational risk for the institution. In general, a financial institution should conduct the level and amount of due diligence for an elevated risk CSFT that is commensurate

with the level of risks identified. A financial institution that structures or markets an elevated risk CSFT to a customer, or that acts as an advisor to a customer or investors concerning an elevated risk CSFT, may have additional responsibilities under the federal securities laws, the Internal Revenue Code, state fiduciary laws or other laws or regulations and, thus, may have greater legal and reputational risk exposure with respect to an elevated risk CSFT than a financial institution that acts only as a counterparty for the transaction. Accordingly, a financial institution may need to exercise a higher degree of care in conducting its due diligence when the institution structures or markets an elevated risk CSFT or acts as an advisor concerning such a transaction than when the institution plays a more limited role in the transaction.

To appropriately understand and evaluate the potential legal and reputational risks associated with an elevated risk CSFT that a financial institution has identified, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal, or other professionals. As with any transaction, an institution should obtain satisfactory responses to its material questions and concerns prior to consummation of a transaction.<sup>8</sup>

In conducting its due diligence for an elevated risk CSFT, a financial institution should independently analyze the potential risks to the institution from both the transaction and the institution's overall relationship with the customer. Institutions should not conclude that a transaction identified as being an elevated risk CSFT involves minimal or manageable risks solely because another financial institution will participate in the transaction or because of the size or sophistication of the customer or counterparty. Moreover, a financial institution should carefully consider whether it would be appropriate to rely on opinions or analyses prepared by or

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<sup>8</sup> Of course, financial institutions also should ensure that their own accounting for transactions complies with applicable accounting standards, consistently applied.

for the customer concerning any significant accounting, tax or legal issues associated with an elevated risk CSFT.

Approval Process. A financial institution's policies and procedures should provide that CSFTs identified as having elevated legal or reputational risk are reviewed and approved by appropriate levels of control and management personnel. The designated approval process for such CSFTs should include representatives from the relevant business line(s) and/or client management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. The personnel responsible for approving an elevated risk CSFT on behalf of a financial institution should have sufficient experience, training and stature within the organization to evaluate the legal and reputational risks, as well as the credit, market and operational risks to the institution.

The institution's control framework should have procedures to deliver the necessary or appropriate information to the personnel responsible for reviewing or approving an elevated risk CSFT to allow them to properly perform their duties. Such information may include, for example, the material terms of the transaction, a summary of the institution's relationship with the customer, and a discussion of the significant legal, reputational, credit, market and operational risks presented by the transaction.

Some institutions have established a senior management committee that is designed to involve experienced business executives and senior representatives from all of the relevant control functions within the financial institution, including such groups as independent risk management, accounting, policy, legal, compliance, and financial control, in the oversight and approval of CSFTs identified as having elevated risks. While this type of management committee may not be appropriate for all financial institutions, a financial institution should

establish processes that assist the institution in consistently managing its elevated risk CSFTs on a firm-wide basis.<sup>9</sup>

If, after evaluating an elevated risk CSFT, the financial institution determines that its participation in the CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions may include declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. Any representations or assurances provided by a customer should be obtained before a transaction is executed and be received from, or approved by, an appropriate level of the customer's management. A financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risk to the institution or would result in a violation of applicable law, regulation or accounting principles.

Documentation. The documentation that financial institutions use to support CSFTs is often highly customized for individual transactions and negotiated with the customer. Careful generation, collection and retention of documents associated with elevated risk CSFTs are important control mechanisms that may help an institution monitor and manage the legal, reputational, operational, market, and credit risks associated with the transaction. In addition, sound documentation practices may help reduce unwarranted exposure to the financial institution's reputation.

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<sup>9</sup> The control processes that a financial institution establishes for CSFTs should take account of, and be consistent with, any informational barriers established by the institution to manage potential conflicts of interest, insider trading or other concerns.

A financial institution should create and collect sufficient documentation to allow the institution to:

- Document the material terms of the transaction;
- Enforce the material obligations of the counterparties;
- Confirm that customers have received any required disclosures concerning the transaction; and
- Verify that the institution’s policies and procedures are being followed and allow the internal audit function to monitor compliance with those policies and procedures.

When an institution’s policies and procedures require an elevated risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation that reflect management’s approval (or disapproval) of the transaction, any conditions imposed by senior management, and the reasons for such action. The institution should retain documents created for elevated risk CSFTs in accordance with its record retention policies and procedures as well as applicable statutes and regulations.

### **C. Other Risk Management Principles for Elevated Risk CSFTs**

General Business Ethics. The board and senior management of a financial institution also should establish a “tone at the top” through both actions and formalized policies that send a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical or legal issues as well as the potential risks to the financial institution that may arise from unethical or illegal behavior. This kind of culture coupled with appropriate procedures should reinforce business-

line ownership of risk identification, and encourage personnel to move ethical or legal concerns regarding elevated risk CSFTs to appropriate levels of management. In appropriate circumstances, financial institutions may also need to consider implementing mechanisms to protect personnel by permitting the confidential disclosure of concerns.<sup>10</sup> As in other areas of financial institution management, compensation and incentive plans should be structured, in the context of elevated risk CSFTs, so that they provide personnel with appropriate incentives to have due regard for the legal, ethical and reputational risk interests of the institution.

Monitoring Compliance with Internal Policies and Procedures. The events of recent years evidence the need for an effective oversight and review program for elevated risk CSFTs. Financial institutions should conduct periodic independent reviews of their CSFT activities to verify that their policies and controls relating to elevated risk CSFTs are being implemented effectively and that elevated risk CSFTs are accurately identified and receive proper approvals. Such monitoring may include more frequent assessments of the risk arising from elevated risk CSFTs, both individually and within the context of the overall customer relationship, and the results of this monitoring should be provided to an appropriate level of management in the financial institution.

Training. An institution should identify relevant personnel who may need specialized training regarding CSFTs to be able to effectively perform their oversight and review responsibilities. Appropriate training on the financial institution's policies and procedures for handling elevated risk CSFTs is critical. Financial institution personnel involved in CSFTs

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<sup>10</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).

should be familiar with the institution's policies and procedures concerning elevated risk CSFTs, including the processes established by the institution for identification and approval of elevated risk CSFTs and new complex structured finance products and for the elevation of concerns regarding transactions or products to appropriate levels of management. Financial institution personnel should be trained to identify and properly handle elevated risk CSFTs that may result in a violation of law.

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. The internal audit department of a financial institution should regularly audit the financial institution's adherence to its own control procedures relating to elevated risk CSFTs, and further assess the adequacy of its policies and procedures related to elevated risk CSFTs. Internal audit should periodically validate that business lines and individual employees are complying with the financial institution's standards for elevated risk CSFTs and appropriately identifying any exceptions. This validation should include transaction testing for elevated risk CSFTs.

Reporting. A financial institution's policies and procedures should provide for the appropriate levels of management and the board of directors to receive sufficient information and reports concerning the institution's elevated risk CSFTs to perform their oversight functions.

#### **IV. CONCLUSION**

Structured finance products have become an essential and important part of the U.S. and international capital markets, and financial institutions have played an important role in the development of structured finance markets. In some instances, however, CSFTs have been used to misrepresent a customer's financial condition to investors and others, and financial

institutions involved in these transactions have sustained significant legal and reputational harm. In light of the potential legal and reputational risks associated with CSFTs, financial institutions should have effective risk management and internal control systems that are designed to allow the institution to identify elevated risk CSFTs, to evaluate, manage and address the risks arising from such transactions, and to conduct those activities in compliance with applicable law.

[THIS SIGNATURE PAGE PERTAINS TO THE NOTICE AND REQUEST FOR COMMENT TITLED, “INTERAGENCY STATEMENT ON SOUND PRACTICES CONCERNING ELEVATED RISK COMPLEX STRUCTURED FINANCE ACTIVITIES.”]

Dated: May , 2006.

John C. Dugan,  
Comptroller of the Currency.

[THIS SIGNATURE PAGE PERTAINS TO THE NOTICE AND REQUEST FOR COMMENT TITLED, “INTERAGENCY STATEMENT ON SOUND PRACTICES CONCERNING ELEVATED RISK COMPLEX STRUCTURED FINANCE ACTIVITIES.”]

Dated: May , 2006

By the Office of Thrift Supervision.

John M. Reich,

Director

[THIS SIGNATURE PAGE PERTAINS TO THE NOTICE AND REQUEST FOR COMMENT  
TITLED, “INTERAGENCY STATEMENT ON SOUND PRACTICES CONCERNING  
ELEVATED RISK COMPLEX STRUCTURED FINANCE ACTIVITIES.”]

By order of the Board of Governors of the Federal Reserve System, May , 2006.

Jennifer J. Johnson,  
Secretary of the Board.

[THIS SIGNATURE PAGE PERTAINS TO THE NOTICE AND REQUEST FOR COMMENT TITLED, “INTERAGENCY STATEMENT ON SOUND PRACTICES CONCERNING ELEVATED RISK COMPLEX STRUCTURED FINANCE ACTIVITIES.”]

Dated at Washington, D.C., the    th day of May, 2006.

By order of the Federal Deposit Insurance Corporation.

Robert E. Feldman,  
Executive Secretary.

[THIS SIGNATURE PAGE PERTAINS TO THE NOTICE AND REQUEST FOR COMMENT TITLED, “INTERAGENCY STATEMENT ON SOUND PRACTICES CONCERNING ELEVATED RISK COMPLEX STRUCTURED FINANCE ACTIVITIES.”]

Dated: May , 2006

By the Securities and Exchange Commission

Nancy M. Morris

Secretary