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## SIFMA COMPLIANCE AND LEGAL DIVISION ANNUAL SEMINAR

### SPEAKER NOTES: SECURITIES ACTIVITIES OF BANKS IN THE GLB ERA: COMPLEX STRUCTURED FINANCE AND OPERATIONAL RISK ISSUES<sup>1</sup>

Phoenix, Arizona  
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#### I. Complex Structured Finance Transactions

- A. The use of derivatives and other complex structured finance transactions, and the role of banks and other financial institutions in structuring these transactions for customers, have come under scrutiny in the wake of the Enron bankruptcy and related regulatory actions and litigation. These actions and proceedings show an increased willingness on the part of courts and regulators to hold financial institutions responsible for participating in transactions that may be deceptive or improperly reported.

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<sup>1</sup> These Speaker Notes (current as of March 19, 2007) are intended as an “addendum” to the more complete Outline -- Securities Activities of Banks in the GLB Era: Complex Structured Finance and Operational Risk Issues (current as of January 15, 2007) -- provided in the Annual Seminar materials (the “Outline”). Terms used in these Speaker Notes and defined in the Outline but not defined herein have the same meanings in these Speaker Notes as they have in the Outline.

- B. The Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities (the “Final Interagency Statement on CSFTs”), 72 Fed. Reg. 1372 (January 11, 2007) -- adopted by the Board (see Fed. Res. Reg. Serv. ¶ 3-1579.452), the OCC, the FDIC, the OTS and the SEC -- offers principles-based guidance to banks and other financial institutions with respect to their involvement in CSFTs.
1. The process that led to the issuance of the Final Interagency Statement on CSFTs began with a Proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. 28980 (May 19, 2004) (the “Initial Proposed Interagency Statement on CSFTs”), and was carried forward in a Revised Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 71 Fed. Reg. 28386 (May 16, 2006) (the “Revised Proposed Interagency Statement on CSFTs”), which was put out for further public comment.
  2. The Revised Proposed Interagency Statement on CSFTs modified the Initial Proposed Interagency Statement on CSFTs to make the Statement more principles-based and focused on the identification, review and approval process for elevated risk CSFTs. The Final Interagency Statement on CSFTs made minor modifications to the Revised Proposed Statement designed to clarify, but not alter, the principles set forth in the Revised Proposed Statement. The Final Statement also describes 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 elevated risk CSFTs.
  3. The Final Interagency Statement on CSFTs starts from the premise that most structured finance transactions -- such as standard securitization arrangements, and hedge strategies that use “plain vanilla” derivatives and collateralized loan obligations -- are not the kind that the Final Statement is intended to cover. Instead, the Final Statement applies only to transactions -- such as those designed to accomplish particular accounting or tax objectives -- that create heightened legal or reputational risk for banking or securities firms. The hallmarks of a non-complex transaction are that it has a well-established track record and is familiar to participants in the financial markets.
  4. The principal areas change from the Revised Proposed Interagency Statement on CSFTs to the Final Interagency Statement on CSFTs include the following.
    - (a) With respect to documentation, the Final Interagency Statement on CSFTs clarified that (i) the requirement of the Statement that a financial institution document (and retain for examination) a record of the reasons that the institution approved (conditionally or

otherwise) or disapproved each elevated risk CSFT would apply only to those elevated risk CSFTs that were brought to the highest level of senior management review, and would not apply to transactions that were disapproved or not pursued as a result of consideration below this level; (ii) the documentation requirement could be satisfied by a high level document, such as the minutes of a committee meeting; and (iii) institutions need only memorialize the “*factors*” considered in connection with the review of a transaction and would not need to memorialize the “*reasons*” for approval or disapproval of a transaction (and, therefore, would not be required to detail comprehensively the institutions’ legal or business analysis of the transaction).

- (b) In terms of an independent review of elevated risk CSFTs the Final Interagency Statement on CSFTs clarified that an institution’s audit or compliance department should have the flexibility, but is not required, to conduct a substantive evaluation of the decisions made in connection with the approval of individual CSFTs.
- (c) In respect of legal ambiguity, the Final Interagency Statement on CSFTs acknowledged that, in certain circumstances, ambiguities may exist as to how applicable law or accounting principles may apply to an elevated risk CSFT, and clarified that the Final Statement does not necessarily require an institution to decline to participate in an elevated risk CSFT based solely on the existence of some ambiguity. The Final Statement reflects the view that it is not appropriate to provide that all transactions initially identified as potentially creating elevated legal or reputational risks for an institution should be considered presumptively prohibited. Rather, if, after evaluating an elevated risk CSFT, a financial institution determines that its participation in the transaction would create risks, the institution should take appropriate steps to manage and address those risks (including modifying the transaction or conditioning the institution’s participation in the transaction on the receipt of representations or assurances from the customer that reasonably address the risks presented).
- (d) In respect of U.S. branches of foreign banks, the Final Interagency Statement on CSFTs clarified that such a branch is not required to establish or adopt separate U.S.-based risk management structures or policies for its CSFT activities, but may apply group-wide structures and policies applicable to its activities so long as the risk management structure and policies used by a U.S. branch, whether adopted or implemented on a group-wide or stand-alone basis, is effective in allowing the branch to manage the risks associated with its CSFT activities.

5. The Final Interagency Statement on CSFTs reaffirms that (a) the Final Statement “does not create any private rights of action, and does not alter or expand the legal duties and financial obligations that a financial institution may have to a customer, its shareholders or other third parties under applicable law”; (b) conversely, adherence to the Final Statement would not insulate an institution from regulatory action or any liability to third parties under applicable law; and (c) the Final Statement does not assuage or condone illegal conduct.
6. In one sense, the general principles behind the Final Interagency Statement on CSFTs are incontrovertible.
  - (a) “Is it ethical?” is where evaluation of a CSFT starts. Furthermore, when analyzing a CSFT, it is important to step back and think about how a disinterested observer would apply the relevant legal principles: “How would it look in The New York Times?” is a reasonable proxy for this test.
  - (b) No bank or broker should (i) engage in any CSFT where it knows or believes that an objective of its counterparty is to achieve a misleading earnings, revenue, tax or balance sheet effect; (ii) enter into any undocumented agreement; or (iii) use some perceived “market practice” -- the “everybody is doing it test” -- as a benchmark for applicable compliance standards.
  - (c) To the contrary, a financial intermediary needs to (i) establish a clear process for review and consideration of any CSFT where a purpose is to achieve a particular economic, accounting, tax, legal or regulatory objective (including an objective to obtain off-balance sheet treatment, to counteract or delay the failure of another transaction, to replace debt with funds characterized as other than debt, or to characterize as something other than a financing what is, in fact, a loan); and (ii) be attentive to CSFTs that could create legal or reputational risks (including CSFTs whose only purpose is to have a financial statement impact) -- to mix a metaphor, the “smell test” has to be alive and well.
  - (d) Lawyers who advise on, or assist financial institutions in structuring, a CSFT may have an obligation to satisfy themselves as to the bona fides of the CSFT. The “mere scrivener” standard will simply not apply, nor will it satisfy appropriate standards simply to be a “slave to a checklist”. It will be important to focus

on what a transaction is trying to accomplish (with special attention to conflicts of interest), in evaluating its propriety.<sup>2</sup>

7. Although the Final Interagency Statement on CSFTs appears to move away from the implications in the Initial Proposed Interagency Statement on CSFTs that a financial intermediary may need to be its “brother’s keeper” in the context of CSFTs in a number of ways,<sup>3</sup> it nonetheless remains the case that:

- (a) It is not sufficient for a financial institution to assume that a counterparty will disclose and account for a CSFT properly, particularly if the CSFT has been structured in a way that could mask its economic effect and if the financial institution knows or has reason to believe that the CSFT could result in materially misleading financial statements.

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<sup>2</sup> Note should be taken of SEC v. RenaissanceRe Holdings Ltd., SEC Litigation Release No. 19989 (February 6, 2007) (SEC settlement of securities fraud charges against a property catastrophe reinsurance company alleging that the insurer created a sham reinsurance transaction that had no economic substance and no purpose other than to smooth and defer its earnings over 3 years, “[i]n effect . . . enabl[ing the insurer] to create a ‘cookie jar’ into which it put excess revenue in one good year, to be pulled out in a future year to increase income”; in settling the SEC’s charges, the insurer agreed to (i) an injunction; (ii) retain an independent consultant to review the design and implementation of counsel/auditor reviews and make recommendations concerning the adequacy of the insurer’s internal controls, audit department and compliance function; and (iii) pay a \$15 million civil penalty).

<sup>3</sup> See generally Regents of the University of California v. Credit Suisse First Boston, et al., No. 06-20856 (5<sup>th</sup> Cir., Mar. 19, 2007) (reversing District Court class action certification; allegation that investment banks entered into partnerships and transactions that allowed Enron to take liabilities off of its books temporarily and to book revenue from the transactions when it was actually incurring debt was not sufficient to ground a class action under SEC Rule 10b-5 in the absence of any allegation that the investment banks were fiduciaries which owed a duty of disclosure to the plaintiffs, that they improperly filed financial reports on Enron’s behalf, or that they engaged in wash sales or other manipulative activities directly in the market for Enron securities; the investment banks “did not owe plaintiffs any duty to disclose the nature of the alleged transactions . . . [W]here the plaintiffs had no expectation that the banks would provide them with information, there is no reason to expect that the plaintiffs were relying on their candor. Accordingly, it is only sensible to put plaintiffs to their proof that they individually relied on the banks’ omissions. . . . Because no class may be certified in a Section 10(b) case without a class wide presumption of reliance, our analysis of reliance disposes of this appeal.”

In order to minimize this risk, a financial intermediary should ascertain how its counterparty intends to report a CSFT, and obtain appropriate assurance that the CSFT has a legitimate business purpose and that its counterparty will comply with applicable law insofar as the CSFT's legal, regulatory, tax, financial and accounting characterizations and disclosures are concerned.

- (b) Recording a CSFT in accordance with generally accepted accounting principles does not fully answer the question as to the propriety of the applicable disclosures.

## II. Operational Risk from a Capital Markets/Legal and Compliance Perspective

### A. Compliance Context

1. The essence of compliance -- and, therefore, the legal aspects of operational risk management -- are embedded in the concept of "supervision", where business management (not a legal or compliance department) has ultimate responsibility to ensure that every element of a banking or securities organization adheres to regulatory and legislative mandates.
2. A recent regulatory pronouncement -- the Proposed Supervisory Guidance in Advance Measurement Approaches for Operational Risk, 72 Fed. Reg. 9170 (February 28, 2007) -- identifies supervisory standards that a financial institution should follow to maintain an AMA system for regulatory capital purposes. However, these standards have a broader applicability than a focus on capital issues; rather, focused as they are on such matters as operational risk management, governance, reporting and assessments, they articulate standards that apply broadly to the establishment of a robust risk management framework that can remain relevant as an institution's risk profile changes over time.

### B. Other Issues Respecting Operational Risk

It is quite clear that the biggest problems from an operational risk perspective are likely to arise for financial institutions in a number of areas.

1. Compliance problems must not be allowed to fester.
2. Conflicts of interest must be pursued and addressed.
  - (a) Conflicts of interest are inherent in any financial services operation. Increasingly, regulators are focusing on how banking and securities organizations identify and resolve conflicts as they arise (i) between the financial institution and its customers, (ii) among the financial institution's customers, and (iii) among different business units of the same financial institution.

- (b) Conflicts of interest which arise from multiple relationships with a customer (e.g., acting as an underwriter and as an adviser to the issuer, acting as market-maker/lender/derivatives counterparty, acting as adviser on M&A transactions coupled with the issuance of fairness opinions, holding principal positions in debt or equity securities, having a director representative on a client's board, etc.) may require special attention so that the potentially increased risk of equitable subordination, incurring fiduciary obligations, additional restrictions on information-sharing, etc., can be addressed.
  - (c) Bottom line: While conflicts are not necessarily to be feared, they must be identified -- a "full-stretch ostrich" approach simply will not work -- and appropriately addressed.
3. "Best practices" in terms of trading strategies and customer/counterparty transactions must be identified and integrated appropriately into the bank/broker-dealer's policies and controls, in particular to guard against manipulative behavior in any market.<sup>4</sup>

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<sup>4</sup> See, e.g., Treasury Market Best Practices (Treasury Market Practice Group Proposed Guidelines, February 9, 2007):

"Best practices are meant to serve as guidelines for market participants seeking to organize their operations in a manner that fosters strong controls and reinforces overall market integrity. The best practices in this document are intended not only for dealers but for any market participant active in the wholesale Treasury market, including brokers, buy-side firms, investors and custodians. We believe that these best practices, if adopted, can strengthen each market participant's existing controls. In addition, we believe that the implementation of these best practices will help reduce market disruptions -- including but not limited to episodes of protracted settlement failure -- and buttress overall market integrity with important benefits for Treasury market participants and the public alike.

"The best practices [relating to such matters as (i) the promotion of market-making and liquidity, (ii) the need to maintain a robust control environment to monitor questionable trading activities, (iii) the management of large long or short positions in the market, and (iv) the promotion of efficient market clearing] seek to affirm existing notions of good market conduct and are intended as useful operational guideposts rather than binding rules or regulatory guidance. As each market participant makes use of these recommendations, it should take into account its own unique characteristics, such as asset size, transaction volume, and the form of the organization's participation in the market (for example, market maker, investor, custodian, etc.)."

(fn. cont.)

4. Attention must be given to those areas where legal compliance is noted, as being of special concern, including:
  - (a) Section 23A/23B and the Board's Regulation W.<sup>5</sup>
  - (b) Anti-tying Statute.
  - (c) Equity investment limitations under banking, securities and other laws, especially in respect of regulated industries.
  - (d) USA PATRIOT Act/BSA/OFAC, including in respect of (i) AML policies, (ii) SAR tracking/monitoring/filing, (iii) implementation of adequate customer identification/know-your-customer procedures, (iv) trade finance, (v) foreign correspondent account review, and (vi) diligence in respect of U.S. and non-U.S. shell companies and tax havens.
5. Internal audits or compliance reviews must not be done in a cursory manner, and their results may not be ignored.

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See also, e.g., Letters, dated February 6, 2007, from Senate Energy and National Resources Committee Chairman Bingaman to Commodity Futures Trading Commission (“CFTC”) and Federal Energy Regulatory Commission (“FERC”), seeking information on regulatory commodity market surveillance programs and on the status of the implementation of the October 2005 CFTC/FERC Memorandum of Understanding on information sharing in the context of natural gas futures transactions relating to Amaranth hedge fund activities and the perceived increased volatility of natural gas prices.

<sup>5</sup> See, e.g., Board Letter to Bank of America, dated January 23, 2007 (exemption under Section 23A in respect of the loan, as principal, by Bank of America, N.A., to its broker-dealer affiliate, Banc of America Securities, of securities pledged to the Bank as collateral under circumstances where the Bank guarantees to the pledgor to return of the securities lent; loan of securities treated as a covered transaction under Section 23A even against receipt of cash collateral).

6. Reputational risk issues must be given serious attention -- it is not always enough to conclude that "it's legal" to satisfy and properly address this risk.

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