

U.S. Banking Regulators and SEC Issue Revised Proposed Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Transactions

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On May 9, 2006, the four federal banking agencies¹ and the Securities and Exchange Commission (“SEC”) published for comment a revised “Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities” (the “Revised Statement”).² The Revised Statement would apply to “financial institutions,” including banks and savings associations and their holding companies (other than foreign banking organizations), registered broker-dealers and investment advisors. U.S. branches and agencies supervised by the OCC, the FRB and the FDIC are also included as financial institutions for purposes of the Revised Statement. Comments on the Revised Statement are due 30 days after publication in the Federal Register.

The Revised Statement replaces an earlier proposed statement of interagency guidance issued for comment on May 19, 2004 (the “2004 Proposal”). The 2004 Proposal attracted significant public comment. Key concerns noted by commenters included that:

- The 2004 Proposal could be construed as imposing on financial institutions new legal duties and responsibilities for ensuring the legality and propriety of their customers’ accounting, disclosure and tax treatment for complex structured finance transactions (“CSFTs”), and that the transactions are “appropriate” or “suitable,” thereby increasing, rather than decreasing, legal risk.
- The 2004 Proposal and the specified internal controls and risk management processes it proposed would be overly prescriptive and burdensome.

¹ The four banking agencies are the Board of Governors of the Federal Reserve System (the “FRB”), the Federal Deposit Insurance Corporation (the “FDIC”), the Office of the Comptroller of the Currency (the “OCC”) and the Office of Thrift Supervision (the “OTS”).

² A copy of the Revised Statement can be accessed through the following internet URL:
<http://www.sec.gov/rules/policy/2006/34-53773.pdf>.

- The 2004 Proposal could be construed as suggesting that even routine, high volume CSFTs that do not entail heightened legal or reputational risk should be subject to heightened review.
- The Proposal would have established unjustifiably cumbersome documentation requirements for CSFTs.

The agencies have proposed substantial revisions to the 2004 Proposal in light of the public comments received by the agencies. The revised proposal aims to clarify and streamline the scope and effect of the statement and to adopt a more principles-based, and less prescriptive, approach to the review of prospective CSFTs. In particular, the Revised Statement focuses on those CSFTs that may pose heightened levels of legal or reputational risk (“elevated risk CSFTs”) rather than more standard structured finance transactions. The principles-based approach taken in the Revised Statement provides greater flexibility for a financial institution to design controls and procedures that can be tailored to the characteristics and scope of its activities and its internal control framework and clarifies that institutions operating in foreign jurisdictions may establish policies and procedures that are tailored to compliance with applicable laws and regulations in those jurisdictions.

The banking agencies propose to adopt the Revised Statement as supervisory guidance, and the SEC proposes to adopt the guidance as a policy statement. The agencies have also added an express provision to the Revised Statement to clarify that it “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.” Conversely, however, adherence to the Revised Statement would not insulate an institution from regulatory action or any liability under applicable law to third parties.

Highlights of the Revised Statement are summarized below.

Identifying Elevated Risk CSFTs

- The Revised Statement would require financial institutions to establish and maintain policies, procedures and systems to identify elevated risk CSFTs.
- The Revised Statement notes that 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 transactions involving “plain vanilla” derivatives and collateralized loan obligations) are familiar to participants in the financial markets and have a well-established track record. These transactions “typically” would not be considered CSFTs for purposes of the Revised Statement.

- Illustrative examples of transactions that an institution may determine warrant additional scrutiny include those that appear to the institution to:
 - lack economic substance or business purpose;
 - be designed or used for questionable accounting, regulatory or tax objectives (particularly at year-end or the end of a reporting period);
 - raise concerns that the client will disclose or report in a materially misleading manner;
 - involve circular transfers of risk that lack economic substance or business purpose;
 - involve oral or undocumented agreements that would have a material impact on regulatory, tax or accounting treatment or disclosure obligations;
 - 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 disproportionate to services, or to the credit, market or operational risk assumed by the institution.
- The Revised Statement emphasizes that the foregoing examples are not exhaustive and that the goal of each financial institution’s policies and procedures remains to identify CSFTs that warrant additional scrutiny in the transaction or new product approval process due to concerns regarding legal or reputational risks.
- Financial institutions may find it helpful to incorporate the review of new CSFTs into their new product policies (including a control process for the approval of new CSFTs). An institution may consider a number of factors in determining whether a CSFT is “new,” including structural or pricing variations from existing products, whether the product targets a new class of customers or a new need of customers, whether it raises new compliance, legal or regulatory issues and whether it would be offered in a manner that would deviate from standard market practices.
- A financial institution operating in foreign jurisdictions may tailor its policies and procedures to account for the laws, regulations and standards of those jurisdictions. U.S. branches and agencies should coordinate their policies with the foreign bank’s group-wide policies developed under the rules of the home country supervisor and should implement a control infrastructure for

CSFTs that is consistent with the institution's overall structure and framework for risk management and controls.

Due Diligence

- The Revised Statement would require financial institutions to implement policies and procedures for heightened due diligence of transactions identified by the institution as elevated risk CSFTs.
- The institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction – focusing in particular on issues potentially creating heightened legal or reputational risks. The level of due diligence should be consistent with the levels of risk identified.
- An institution that structures or markets an elevated risk CSFT or acts as an advisor concerning a transaction may need a higher degree of care in its due diligence than an institution that plays a more limited role in the transaction.
- The Revised Statement notes that an institution may find it useful or necessary to obtain additional information from a customer or to obtain specialized advice from accounting, tax, legal or other professionals.
- An institution should consider whether it would be appropriate to rely on opinions or analyses prepared by or for the customer concerning accounting, tax or legal issues.

Approval Process

- A financial institution should have policies and procedures to ensure review and approval of elevated risk CSFTs by appropriate levels of control and management personnel with sufficient experience, training and organizational stature, including representatives of appropriate control areas that are independent of the business lines involved.
- The Revised Statement notes that some institutions have established senior management committees designed to include all of the relevant control functions (e.g., independent risk management, accounting, policy, legal, compliance and financial control) in the approval and oversight of elevated risk CSFTs. Although the Revised Statement notes that such a management committee may not be appropriate for all institutions, it emphasizes that a financial institution should establish a process to manage elevated risk CSFTs consistently on a firm-wide basis.
- An institution should take steps to address significant legal or reputational risks, which may include declining to participate in the transaction, modifying the transaction or conditioning participation upon receipt of

representations or assurances from the customer that reasonably address the heightened legal or reputational risks. An institution should decline to participate if it determines the transaction presents unacceptable risk or would result in a violation of law, regulations or accounting principles.

Documentation

- An institution should create and collect sufficient documentation to:
 - document the material terms of the transaction;
 - enforce the material obligations of counterparties;
 - confirm that customers have received any required disclosures concerning the transactions; and
 - verify that policies and procedures are being followed and allow internal audit to monitor compliance with those policies and procedures.
- Where the institution's policies and procedures require senior management approval of an elevated risk CSFT, documentation presented to management and documentation reflecting approval or disapproval, any conditions imposed by senior management and the reasons for such action should be maintained.

Other Risk Management Principles

- General Business Ethics. The board and senior management should establish a tone at the top to create a firm-wide culture and procedures that are sensitive to ethical or legal issues as well as potential risks to the institution. The Revised Statement notes that financial institutions may need to consider implementing mechanisms to protect personnel by permitting confidential disclosure of concerns.
- Monitoring. Institutions should conduct periodic independent reviews of CSFT activities to verify that procedures and controls are being implemented effectively and that elevated risk CSFTs are accurately identified and receive proper approvals.
- Training. Relevant personnel involved in CSFTs should be familiar with the institution's policies and procedures, including processes for the identification and approval of elevated risk CSFTs and new complex structured finance products and for elevating concerns to appropriate levels of management.

- Audit. Internal audit should regularly audit the institution's compliance with its policies and procedures (and the adequacy of such policies and procedures related to elevated risk CSFTs). Periodic validations should include transaction testing.
- Reporting. An institution's policies and procedures should provide for the appropriate levels of management and the board to receive information concerning elevated risk CSFTs in order to perform their oversight functions.

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