

**DEPARTMENT OF THE TREASURY  
Office of the Comptroller of the Currency  
[Docket No. 04-12]**

**Office of Thrift Supervision  
[No. 2004-27]**

**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  
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).

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

**SUMMARY:** The OCC, OTS, Board, FDIC, and SEC (collectively, the Agencies) are requesting public comment on a proposed interagency statement concerning the complex structured finance activities of financial institutions (national and state banks; bank holding companies; federal and state savings associations; savings and loan holding companies; and SEC-registered broker-dealers and investment advisors) supervised by the Agencies. As recent events have highlighted, a financial institution may assume substantial reputational and legal risk if the institution enters into a complex structured finance transaction with a customer and the customer uses the transaction to circumvent regulatory or financial reporting requirements, evade tax liabilities, or further other illegal or improper behavior. The proposed interagency statement (Statement) describes the types of internal controls and risk management procedures that the Agencies believe are particularly effective in assisting financial institutions to identify and address the reputational, legal, and other risks associated with complex structured finance transactions. The Statement, among other things, provides that financial institutions should have effective policies and procedures in place to identify those complex structured finance transactions that may involve heightened reputational and legal risk, to ensure that these transactions receive enhanced scrutiny by the institution, and to ensure that the institution does not participate in illegal or inappropriate transactions.

**DATES:** Comments regarding the Statement should be received on or before [INSERT DATE 30 DAYS AFTER PUBLICATION IN FEDERAL REGISTER]. Comments regarding the information collections contained in the Statement should be received on or before [INSERT DATE 60 DAYS AFTER PUBLICATION IN FEDERAL REGISTER].

**ADDRESSES:**

- **Comments:** Your comment must designate “OCC” and include Docket Number or Regulatory Information Number (RIN) \_\_\_\_\_. In general, the OCC will enter all comments received into the docket without change, including any business or personal information that you provide. Because paper mail in the Washington area and at the OCC may be subject to delays, please submit your comment by e-mail or fax whenever possible. However, you may submit your comment 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." Next, 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., Public Information Room, 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.

- **Docket Information:** For access to the docket to read comments received or background documents you may:

**View Docket Information in Person:** You may personally inspect and photocopy docket information at the OCC's Public Information Room, 250 E Street, SW., Washington, DC. You can make an appointment to inspect the docket by calling us at (202) 874-5043.

**View Docket Information Electronically:** You may request that we send you an electronic copy of docket information via e-mail or CD-ROM by contacting [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

**Request Paper Copy:** You may request that we send you a paper copy of docket information by faxing us at (202) 874-4448, by calling us at (202) 874-5043, or by mailing the OCC at 250 E Street, SW., Attn: Public Information Room, Mail Stop 1-5, Washington, DC 20219.

**OTS:** You may submit comments, identified by No. 2004-27, 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. 2004-27 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. 2004-27.
- **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. 2004-27.

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, except as necessary 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>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-22-04 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, D.C. 20549-0609.

All submissions should refer to File Number S7-22-04. 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>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, D.C. 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, (202) 874-4660, Risk Evaluation, Grace E. Dailey, Deputy Comptroller, (202) 874-4610, Large Bank Supervision, Ellen Broadman, Director, (202) 874-5210, Securities and Corporate Practices Division, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, D.C. 20219.

**OTS:** John C. Price, Jr., Director, Supervision Policy, Examinations and Supervision Policy, (202) 906-5745; Debbie Merkle, Project Manager, Credit Risk, Supervision Policy, (202) 906-5688; David A. Permut, Senior Attorney, Business Transactions Division, (202) 906-7505, Office of Thrift Supervision, 1700 G Street, NW., Washington, D.C. 20552.

**BOARD:** Michael G. Martinson, Senior Adviser (202-452-3640), Walt H. Miles, Assistant Director (202) 452-5264, or Sabeth I. Siddique, Manager (202) 452-3861, Division of Banking Supervision and Regulation; or Kieran J. Fallon, Managing Senior

Counsel (202) 452-5270, Legal Division, Board of Governors of the Federal Reserve System, 20<sup>th</sup> Street and Constitution Avenue, NW., Washington, D.C. 20551. Users of Telecommunication Device for Deaf (TTD) only, call (202) 263-4869.

**FDIC:** William A. Stark, Associate Director, Capital Markets Branch, (202) 898-6972, Jason C. Cave, Chief, Policy Section, Capital Markets Branch, (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 17<sup>th</sup> Street, NW., Washington, D.C. 20429.

**SEC:** Mary Ann Gadziala, Associate Director, or Juanita Bishop, Supervisory Accountant at (202) 942-7400, Office of Compliance Inspections and Examinations, or Catherine McGuire, Chief Counsel, Linda Stamp Sundberg, Attorney Fellow, or Randall W. Roy, Special Counsel, at (202) 942-0073, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, D.C. 20549-1001.

## **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 the allocation of risk among borrowers and investors in more efficient ways. This innovation has led to the development of a wide array of structured finance products, including financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, and specialized financial conduits that manage pools of purchased assets.

National and state banks, bank holding companies, and SEC-registered broker-dealers and investment advisers have played an active and important role in the development of structured finance products and markets. In this regard, financial institutions often play an important role in structuring, arranging or participating in complex structured finance transactions for their own use and to facilitate the needs of customers.

As financial intermediaries, financial institutions play a critical role in ensuring the integrity of financial markets and maintaining the trust and public confidence essential to the proper functioning of the capital markets. In the vast majority of cases, structured finance products and the role played by financial institutions with respect to these products have served the legitimate business purposes of customers. This has allowed structured finance products to become an essential part of U.S. and international capital markets.

The more complex variations of structured finance products, however, have placed pressure on the interpretations of accounting and tax rules, and, in turn, have given rise to significant concerns about the legality and appropriateness of certain individual transactions. Importantly, a limited number of complex structured finance transactions

appear to have been used to alter the appearance of a customer's public financial statements in ways that are not consistent with the economic reality of the transactions or to inappropriately reduce a customer's tax liabilities. In the most extreme cases, structured finance transactions appear to have been used in fraudulent schemes to misrepresent the financial condition of public companies or evade taxes.

Financial institutions must conduct their operations in compliance with applicable law and regulations, and institutions that do not may be subject to enforcement actions by the Agencies and lawsuits by private parties. As recent events have highlighted, financial institutions may face substantial legal risk to the extent they participate in complex structured finance transactions that are used by customers to circumvent regulatory or financial reporting requirements, evade tax liabilities, or further other illegal or improper behavior by the customer. Involvement in such transactions also may damage an institution's reputation and franchise value. Reputational risk poses a major threat to financial institutions because the nature of their business requires maintaining the confidence of customers, creditors, and the general marketplace. Importantly, reputational risks may arise even where the transactions involved are structured to technically comply with existing laws and regulations.

The events associated with Enron Corp. demonstrate the potential for the abusive use of complex structured finance transactions, as well as the substantial legal and reputational risks that financial institutions face when they participate in complex structured finance transactions that are designed or used for improper purposes. 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 participated in complex structured finance transactions with Enron Corp. that appeared to have been designed or used to shield the company's true financial health from the public.<sup>1</sup> These actions involved significant financial penalties on the institutions and required the institutions to take several measures to strengthen their risk management practices for complex structured finance activities. The structured finance relationships between some financial institutions and Enron Corp. also sparked an investigation by the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Governmental Affairs,<sup>2</sup> as well as numerous lawsuits by private litigants.

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<sup>1</sup> See 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 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.).

<sup>2</sup> See Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and  
(continued . . .)

The Agencies have long expected financial institutions to develop and maintain robust control infrastructures enabling them fully to identify, evaluate and control all dimensions of risk associated with their business activities. In the area of complex structured finance transactions, it is critical that financial institutions have effective risk management and internal controls to ensure that the institutions' activities comply with the law and that all of the risks associated with a transaction—including legal and reputational risks—are identified and appropriately addressed.

In light of recent events, the OCC, Board, and SEC conducted special reviews of several banking and securities firms that are significant participants in the market for complex structured finance products. These reviews were designed to evaluate the 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 complex structured finance transactions. These assessments indicated that many financial institutions have already taken meaningful steps to improve their control infrastructures relating to complex structured finance products in light of the control weaknesses evidenced by recent events. The Agencies also have focused attention on the complex structured finance activities of financial institutions in the normal course of our supervisory process.

## **II. PROPOSED STATEMENT ON SOUND PRACTICES CONCERNING THE COMPLEX STRUCTURED FINANCE ACTIVITIES OF FINANCIAL INSTITUTIONS**

In order to help ensure that financial institutions have and maintain adequate control infrastructures for complex structured finance transactions, the Agencies have developed, and are seeking public comment on, the attached Statement included at the end of this notice.<sup>3</sup> The Statement describes a number of internal controls and risk management procedures that the Agencies believe are particularly useful in assisting financial institutions to ensure that their complex structured financial activities are conducted in accordance with applicable law and that institutions effectively manage the full range of risks associated with these activities, including legal and reputational risks. The Statement reflects the “lessons learned” from recent events, as well as what the Agencies believe to be sound practices in this area based on supervisory reviews and experience. Financial institutions should consider the Statement in developing and evaluating the institution's risk controls for complex structured finance activities. The following provides a brief overview of the key aspects of the Statement.

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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>3</sup> For institutions supervised by the Board, the OCC, the OTS, and the FDIC the statement will represent supervisory guidance. For institutions registered with the SEC, the statement will represent a policy statement.

As a general matter, the Statement indicates that financial institutions offering complex structured finance transactions should maintain a comprehensive set of formal, firm-wide policies and procedures that provide for the identification, documentation, evaluation, and control of the full range of credit, market, operational, legal, and reputational risks that may be associated with these transactions. These policies and procedures should be designed to ensure that the financial institution consistently and appropriately manages its complex structured finance activities on both a per transaction and relationship basis, with all customers (including corporate entities, government entities, and individuals) and in all jurisdictions where the financial institution operates.

The board of directors of a financial institution has ultimate responsibility for establishing the institution's risk tolerances for complex structured finance transactions and ensuring that a sufficiently strong risk control framework is in place to guide the actions of the financial institution's personnel. The board of directors and senior management also should send a strong message to others in the financial institution about the importance of integrity, compliance with the law, and overall good business ethics, which may be implemented through a Code of Professional Conduct.

As described further in the Statement, an institution's policies and procedures should define what constitutes a complex structured finance transaction and should, among other things—

- Define the process that financial institution personnel must follow to obtain approval for complex structured finance transactions;
- Establish a control process for the approval of all “new” complex structured finance products;
- Ensure that the reputational and legal risks associated with a complex structured finance transaction, or series of transactions, are identified and evaluated in both the transaction and new product approval process and appropriately managed by the institution;
- Ensure that financial institution staff appropriately reviews and documents the customers' proposed accounting treatment of complex structured finance transactions, financial disclosures relating to the transactions, and business objectives for entering into the transactions;
- Provide for the generation, collection and retention of appropriate documentation relating to all complex structured finance transactions;
- Ensure that senior management and the board of directors of the institution receive appropriate and timely reports concerning the institution's complex structured finance activities;
- Provide for periodic independent reviews of the institution's complex structured finance activities to ensure that the institution's policies and controls are being implemented effectively and to identify potential compliance issues;
- Ensure effective internal audit coverage of the institution's complex structured finance activities; and



- Ensure that financial institution personnel receive appropriate training concerning the institution's policies and procedures governing its complex structured finance activities.

An institution should establish a clear process for identifying those complex structured finance transactions that involve heightened legal and reputational risks. Once a transaction is identified as involving potentially heightened legal or reputational risk, the institution should ensure that these transactions receive an elevated and thorough review. If, after conducting this review, the financial institution determines that a proposed transaction may result in the customer filing materially misleading financial statements, the financial institution should decline to participate in the transaction, condition its participation upon the customer making express and accurate disclosures regarding the nature and financial impact of the transaction on the customer's financial condition, or take other steps to ensure that the financial institution does not participate in an inappropriate transaction.

The Statement includes examples of characteristics that may indicate that a transaction or series of transactions involves elevated levels of legal or reputational risk and, thus, should be subject to heightened review by the institution. The examples included in the Statement are not exclusive and institutions may differ in the sets of characteristics they use in identifying transactions that may involve heightened risks. Institutions, however, should be conservative when establishing these characteristics and the ultimate goals of all institutions should remain the same—to identify those transactions that require additional scrutiny at inception and to ensure that transactions receive a level of review that is commensurate with the legal and reputational risks associated with the transaction.

Because the Statement discusses sound practices related to complex structured finance activities—activities that typically are conducted only by larger financial institutions—the Statement would not be relevant and, therefore, would not apply to most small institutions. Moreover, an institution's policies and procedures concerning complex structured finance activities should be tailored to, and appropriate in light of, the institution's size and the nature, scope, and risk of its complex structured finance activities.

The Agencies request comment on all aspects of the Statement and will revise the Statement as appropriate after a review of public comments.

### **III. PAPERWORK REDUCTION ACT**

The Board, the FDIC, the OTS, and the OCC have determined that the Statement, which will represent supervisory guidance for institutions supervised by the Board, the FDIC, the OTS, and the OCC, contains collections of information for purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35). The OCC, the FDIC, the OTS, and Board request public comment on all aspects of the collections of information contained in the Statement. Also, the OCC, FDIC, OTS, and Board request comment on

whether institutions involved in complex structured finance transactions currently are in compliance with the Statement and the information collections therein.

The OCC, FDIC, OTS, and Board also invite comment on:

(1) Whether the collections of information contained in the Statement are necessary for the proper performance of each agency's functions, including whether the information has practical utility;

(2) The accuracy of each agency's estimate of the burden of the proposed information collections;

(3) Ways to enhance the quality, utility, and clarity of the information to be collected;

(4) Ways to minimize the burden of the information collections on respondents, including the use of automated collection techniques or other forms of information technology; and

(5) Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information.

Respondents/record keepers are not required to respond to these collections of information unless the Board, the FDIC, the OTS, and OCC display a currently valid Office of Management and Budget (OMB) control number. The OCC, FDIC, and OTS currently are requesting approval of these information collections from OMB, and the Board is processing this collection under its delegated authority.

The OCC, FDIC, OTS, and Board estimates of the total annual burden of the collections of information contained in the Statement on the financial institutions they supervise follow.

**OCC:** The collection of information requirements contained in the Statement will be submitted to the OMB in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35). The OCC will use any comments received to evaluate the collections and verify its burden estimates. The OCC believes that only the largest national banks and U.S. branches of foreign banks are involved in these activities. Further, as a matter of usual and customary business practice and in light of recent events, involved institutions already have installed policies and procedures similar to those envisioned in the Statement. However, institutions will have to verify and update their policies and procedures periodically to ensure that they are adequate and current.

Comments on the collections of information should be sent to John Ference or Camille Dixon, Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 8-4, Attention: Docket Number 04-12 (1557-CSFA), Washington, D.C. 20219. You may also send comments by electronic mail to [camille.dixon@occ.treas.gov](mailto:camille.dixon@occ.treas.gov). You should also send a copy of your comments to OMB Desk Officer, Mark Menchik, Office of Information and Regulatory Affairs, Office of Management and Budget, Paperwork Reduction Project (1557-CSFA), Washington, D.C. 20503. Alternatively, you may e-mail your comments to [mmenchik@omb.eop.gov](mailto:mmenchik@omb.eop.gov), or fax them to (202) 395-6974.

The potential respondents are the largest national banks and U.S. branches of foreign banks.

Estimated number of respondents: 21

Estimated average annual burden hours per respondent: 100 hours.

Estimated total annual burden: 2,100 burden hours.

**FDIC:** The collection of information requirements contained in the Statement will be submitted to the OMB in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35). The FDIC will use any comments received to evaluate the collections and verify its burden estimates. The FDIC believes that only the largest state nonmember banks are involved in these activities. Further, as a matter of usual and customary business practice and in light of recent events, involved institutions already have installed policies and procedures similar to those envisioned in the Statement. However, institutions will have to verify and update their policies and procedures periodically to ensure that they are adequate and current.

Comments on the collections of information should be sent to Thomas Nixon, Legal Division, Federal Deposit Insurance Corporation, 550 17<sup>th</sup> Street NW., Washington, D.C. 20429. Comments may be hand-delivered to the guard station at the rear of the 17<sup>th</sup> Street Building (located on F Street), on business days between 7:00 a.m. and 5:00 p.m. Comments should also be submitted to the OMB desk officer for the FDIC: Mark Menchik, Office of Information and Regulatory Affairs, Office of Management and Budget, New Executive Office Building, Washington, D.C. 20503. Alternatively, you may e-mail your comments to [mmenchik@omb.eop.gov](mailto:mmenchik@omb.eop.gov), or fax them to (202) 395-6974.

The potential respondents are the largest state nonmember banks.

Estimated number of respondents: 5

Estimated average annual burden hours per respondent: 100 hours.

Estimated total annual burden: 500 burden hours.

**OTS:** The collection of information requirements contained in the Statement will be submitted to OMB in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35). OTS will use any comments received to evaluate the collections and verify its burden estimates. The OTS assumes that only the largest savings associations and savings and loan holding companies could be involved in these activities. Further, as a matter of usual and customary business practice and in light of recent events, involved institutions already have installed policies and procedures similar to those envisioned in the Statement. However, institutions will have to verify and update their policies and procedures periodically to ensure that they are adequate and current.

Send comments, referring to the collection by title of the proposal, to Information Collection Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, D.C. 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 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 [publicinfo@ots.treas.gov](mailto:publicinfo@ots.treas.gov), or send a facsimile transmission to (202) 906-7755. You should also send a copy of your comments to OMB Desk Officer, Mark Menchik, Office of Information and Regulatory Affairs, Office of Management and Budget, Paperwork Reduction Project (1550-NEW), Washington, D.C. 20503. Alternatively, you may e-mail your comments to [mmenchik@omb.eop.gov](mailto:mmenchik@omb.eop.gov), or fax them to (202) 395-6974.

The potential respondents are the largest savings associations and savings and loan holding companies.

Estimated number of respondents: 5.

Estimated average annual burden hours per respondent: 100 hours.

Estimated total annual burden: 500 burden hours.

**Board:** In accordance with section 3506 of the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35; 5 CFR 1320, appendix A.1), the Board reviewed the Statement under the authority delegated to the Board by the OMB. The Board believes that only the largest state member banks, bank holding companies, and U. S. branches and agencies of foreign banks are involved in complex structured finance activities. Further, as a matter of usual and customary business practice and in light of recent events, involved institutions already have adopted policies and procedures similar to those envisioned in the Statement. However, the institutions will have to verify and update their policies and procedures periodically to ensure that they are adequate and current.

Comments on the collections of information should be sent to Michelle Long, Acting Federal Reserve Board Clearance Officer, Division of Research and Statistics, Mail Stop 41, Board of Governors of the Federal Reserve System, Washington, D.C. 20551. You should also send a copy of your comments to OMB Desk Officer, Mark Menchik, Office of Information and Regulatory Affairs, Office of Management and Budget, Paperwork Reduction Project (1557-To Be Determined), Washington, D.C. 20503. Alternatively, you may e-mail your comments to [mmenchik@omb.eop.gov](mailto:mmenchik@omb.eop.gov), or fax them to (202) 395-6974.

The potential respondents are the largest state member banks, bank holding companies, and U. S. branches and agencies of foreign banks.

Estimated number of respondents: 20.

Estimated average annual burden hours per respondent: 100 hours.

Estimated total annual burden: 2,000 hours.

The proposed Statement follows.

## **INTERAGENCY STATEMENT ON SOUND PRACTICES CONCERNING 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 purchased assets, along with other structured transactions have usually served the legitimate business purposes of the customers of financial institutions and are an essential part of U.S. and international capital markets.

Financial institutions have played an active and important role in the development of structured finance products and markets. Structured finance transactions are often employed to manage risk or for other legitimate business purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. The more complex variations of selected structured finance transactions have, however, placed pressure on the interpretations of accounting and tax rules, and this has given rise to significant concerns about the risks associated with certain individual transactions. More so, a limited number of transactions appear to have been used primarily to alter the appearance of a customer's public financial statements in ways that are not consistent with the economic reality of the transactions or to inappropriately reduce a customer's tax liabilities. In the most extreme cases, structured finance transactions appear to have been used in fraudulent schemes primarily to misrepresent the financial condition of public companies or evade taxes. Some financial institutions have been subject to criminal sanctions, and civil and administrative enforcement actions by the regulatory agencies, for participating in complex structured finance transactions used by a public company in reporting false or misleading financial statements.

Financial institutions are in a unique position given their role in structuring, arranging or participating in complex structured finance transactions for their own use and to facilitate the needs of their customers. When a financial institution provides advice on, arranges or actively participates in a complex structured finance transaction, it assumes the usual market, credit, and operational risks and also may assume substantial reputational and legal risk to the extent that an end-user enters into the transaction for improper purposes. Considering the inherent complexity of many structured finance transactions and the many risks associated with these transactions, it is critical that financial institutions have effective risk management and internal controls relating to these products to ensure compliance with the law and to effectively monitor and control the risks associated with these transactions. Financial institutions may not engage in complex structured finance transactions in violation of the law and institutions that violate the law may be subject to enforcement action and civil or criminal penalties.

The regulatory agencies have long expected financial institutions to develop and maintain robust control infrastructures enabling them to fully identify, evaluate and control all dimensions of risk associated with their business activities. In the wake of recent developments, 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 U.S. Securities and Exchange Commission are issuing

this guidance to financial institutions that we supervise (“financial institutions” or “institutions”)<sup>1</sup> to describe a number of internal controls and risk management procedures that we believe are useful to effectively manage the risks associated with complex structured finance transactions.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this guidance draws heavily on controls and procedures that our agencies previously have found to be effective in managing and controlling risks and identifies ways in which these controls and procedures can effectively be applied to the institution’s complex structured finance activities. Financial institutions should consider this guidance in developing, or evaluating existing, risk controls for complex structured finance activities. These risk controls should supplement the financial institution’s more general internal controls and risk management systems, as appropriate.

## **II. DEFINITION AND KEY RISKS OF COMPLEX STRUCTURED FINANCE TRANSACTIONS**

Structured finance transactions encompass a broad array of products with varying levels of complexity. This guidance addresses complex structured finance transactions, which usually share several common characteristics. First, they typically result in a final product that is often non-standard and structured to meet the specific financial objectives of a customer. Second, they often involve professionals from multiple disciplines within the financial institution and may have significant fees or high returns in relation to the market and credit risks associated with the transaction. Third, they may be associated with the creation or use of one or more special purpose entities (SPEs) designed to address the economic, legal, tax or accounting objectives of the customer and/or the combination of cash and derivative products. Finally, and perhaps most importantly, they may expose the financial institution to elevated levels of market, credit, operational, legal or reputational risks. These criteria are not exclusive and institutions should supplement or modify these criteria as appropriate to reflect the institution’s business activities and changes in the marketplace.

Financial risks include, among other things, market and credit risks. Due to their inherent complexity, financial institutions participating in complex structured finance

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<sup>1</sup> These institutions are national banks in the case of the Office of the Comptroller of the Currency; federal and state savings associations and savings and loan holding companies in the case of the Office of Thrift Supervision; state member banks and bank holding companies in the case of the Federal Reserve Board; state nonmember banks in the case of the Federal Deposit Insurance Corporation; and registered broker-dealers and investment advisers in the case of the Securities and Exchange Commission. The U.S. branches and agencies of foreign banks supervised by the Federal Reserve Board, the Office of the Comptroller, and the Federal Deposit Insurance Corporation also are considered to be financial institutions for purposes of this guidance.

transactions also may face heightened reputational or legal risk. Financial institutions have been sued due to their involvement in complex structured finance transactions that allegedly facilitated the deceptive accounting or financial reporting practices of certain public companies. Legal risk also may arise in other situations if the financial institution is involved in transactions that are used by customers to circumvent regulatory or financial reporting requirements, evade tax liabilities, or further other illegal or improper behavior by the customer.<sup>2</sup> Besides creating legal risks, these transactions may create substantial reputational risk for the institution. Reputational risk poses a major threat to financial institutions because the nature of their business requires maintaining the confidence of customers, creditors and the general marketplace. Importantly, reputational risks may arise even where the transactions involved are structured to technically comply with existing laws and regulations and accounting standards.

Accordingly, financial institutions need to have strong controls to ensure that their actions with respect to complex structured finance transactions—including structuring, marketing, sales, funding and trading activities—are conducted in accordance with applicable laws and regulations, and to ensure that the institution identifies and appropriately addresses the potential reputational risks involved in these transactions. As discussed further under “Reputational and Legal Risk,” an institution’s policies and procedures should identify those complex structured finance transactions that may warrant enhanced scrutiny due to factors related specifically to reputational and legal risk.

Although the foregoing (and this document more generally) highlights some of the most significant risks associated with complex structured finance transactions, it is not intended to present a full exposition of the risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory information prepared by the agencies for further information concerning market, credit, operational, legal and reputational risks.

### **III. GUIDELINES FOR INCORPORATING STRUCTURED FINANCE TRANSACTIONS INTO EXISTING MANAGEMENT PROCEDURES, CONTROLS AND SYSTEMS**

#### **Role of Board and Management**

The board of directors (the Board) of a financial institution is elected by and accountable to shareholders, and is the focal point of the corporate governance system.

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<sup>2</sup> For additional guidance concerning when a financial institution’s participation in a complex structured finance transaction may violate the Federal securities laws, and the bases for such potential liability, 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)).

Effective oversight by the boards of directors of public institutions is fundamental to preserving the integrity of capital markets. The board of directors, in its oversight role, is ultimately responsible for the financial well being of the institutions they oversee, as well as ensuring that the risks associated with the firm's business activities, including those activities associated with the offering and delivery of complex structured finance transactions, are appropriately identified, evaluated and controlled by management. The Board should establish the financial institution's threshold for the risks associated with complex structured finance products and ensure that a sufficiently strong risk control framework is in place to guide the actions of the financial institution's personnel. The Board should ensure that the financial institution has a risk control framework for complex structured finance transactions that includes comprehensive policies that address the elements described below.

Using guidance provided by the Board, senior management should implement a risk control framework for complex structured finance transactions that includes comprehensive policies, defined roles and responsibilities and approval authorities, detailed management reporting, required documentation, and ongoing independent monitoring and testing of policy compliance. In order to manage the risks associated with complex structured finance transactions, some institutions have established a senior management committee that is designed to ensure that all of the relevant control functions within the financial institution, including independent risk management, accounting policy, legal, and financial control, are involved in the oversight of complex structured finance transactions. The goal of such a senior-level risk control committee is to ensure that those complex structured finance activities that may expose the financial institution to higher levels of financial, legal and reputational risk are comprehensively and consistently managed and controlled on a company-wide basis. This senior management committee regularly reviews trends in new products and complex structured transaction activity, including overall risk exposures from such transactions, and typically provides final approval of the most complicated or controversial complex structured finance transactions. The agencies believe that such a senior-level committee can serve as an important part of an effective control infrastructure for complex structured finance activities.<sup>3</sup>

The Board and senior management also should send a strong message to others in the financial institution about the importance of integrity, compliance with the law, and overall good business ethics, which may be implemented through a Code of Professional Conduct. The Board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical issues as well as the potential risks to the financial institution. The financial institution's culture and procedures should encourage personnel to elevate ethical concerns regarding a complex structured finance transaction

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



or series of transactions to appropriate levels of management. Establishing a culture that encourages financial institution personnel to elevate concerns to appropriate levels of management may require mechanisms to protect personnel by permitting confidential disclosure in appropriate circumstances.<sup>4</sup> Additionally, the Board and senior management should ensure that incentive plans are not structured in a way that encourages transactors to cross ethical boundaries when executing complex structured finance transactions.

## **Policies and Procedures**

Financial institutions offering complex structured finance transactions should maintain a comprehensive set of formal, firm-wide policies and procedures that provide for the identification, documentation, evaluation, and control of the full range of credit, market, operational, legal, and reputational risks that may be associated with these transactions. These policies should start with the financial institution's definition of what constitutes a complex structured finance transaction and be designed to ensure that the financial institution appropriately manages its complex structured finance activities on both an individual transaction and a relationship basis, with all customers (including corporate entities, government entities and individuals) and in all jurisdictions where the financial institution operates.<sup>5</sup> These policies may be developed specifically for complex structured finance transactions or included in the set of broader policies governing the institution generally.

To be most effective, the institution's policies and procedures relating to complex structured finance transactions should specifically set forth the particular responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of these transactions. Accordingly, these policies and procedures should address responsibilities of personnel from sales and trading, relationship management, market risk, credit risk, operations, accounting, legal, compliance, audit and senior line management. The financial institution's policies and procedures should provide a clear framework for the approval and monitoring of complex structured finance transactions. Policies for relevant personnel should describe responsibilities for working with relationship managers, advising and counseling customers, disclosing information to customers, and providing relevant information to control areas.

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<sup>4</sup> The agencies note that the Sarbanes-Oxley Act of 2002 requires companies listed on a national securities exchange or inter-dealer quotation system of a national securities association to establish procedures that enable employees to submit concerns regarding questionable accounting or auditing matters on a confidential, anonymous basis. See 15 U.S.C. 78j-1(m).

<sup>5</sup> In the case of U.S. branches and agencies of foreign banks, these policies should be coordinated with the group-wide policies developed in accordance with the rules of the foreign bank's home supervisor.

The institution's policies should ensure that the market, credit, and operational risk associated with individual complex structured transactions are appropriately identified, aggregated, and managed. A financial institution should, at a minimum, also have procedures, controls and systems for complex structured finance activities that address the following: (1) transaction approval, (2) new product approval, (3) reputational and legal risk, (4) accounting and disclosure by the customer, (5) documentation, (6) reporting, (7) independent monitoring, analysis and compliance with internal policies, (8) audit, and (9) training.

### **Transaction Approval**

The policies and procedures of a financial institution should define the process that personnel must follow to obtain approval for a complex structured finance transaction. Policies for approving complex structured finance transactions should clearly articulate the roles and responsibilities of both transactors (e.g. personnel from origination, structuring, execution, sales and trading areas) and independent control staff (e.g. personnel from risk management, accounting policy, legal, and financial control) in analyzing, approving, and documenting proposed transactions. Policies should guide front office personnel in meeting their responsibilities to provide information on customer objectives and key risk issues (including those described below) to the appropriate approving personnel. Furthermore, it is imperative that the approving authority includes representatives from appropriate control areas that are independent of the transactors. Approving personnel should have appropriate experience and stature in the financial institution to ensure proper consideration of elements or factors that may expose the institution to higher levels of credit, market, operational, legal or reputational risk. While acknowledging its ultimate responsibility for the approval of complex structured finance transactions, the organization's policies also should clearly outline when third-party legal professionals should be engaged to review and opine on transactions, and when third-party accounting or tax professionals should be engaged to consult on transactions.

### **New Product Policies**

Complex structured finance transactions also should be incorporated into a financial institution's new product policies. In this regard, a financial institution's policies should include a definition of what constitutes a "new" complex structured finance product and should establish a control process for the approval of each new product. In determining whether or not a complex structured finance transaction is "new," a financial institution should consider a variety of factors, including any structural variations from existing products, whether the product is targeted at a new class of customers, pricing variations from existing products, whether the product raises additional or new legal, compliance or regulatory issues, and deviations from standard market practices. When in doubt as to whether a complex structured finance transaction requires vetting through the new product approval process, financial institution personnel should err on the side of conservatism and route the proposed product through the process dictated in the new product approval policy. The new product policies for complex

structured finance activities should address the roles and responsibilities of all relevant parties, including the front office, credit risk, market risk, operations, accounting, legal, compliance, audit and senior line management. In addition, it is imperative that the institution's policies require that new products receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

A financial institution also should have in place controls that are designed to ensure that new complex structured finance products are, in fact, subjected to the institution's established approval process. Moreover, subsequent to the new product approval, the financial institution should monitor new complex structured finance products to ensure that they are effectively incorporated into the institution's risk control systems.

### **Reputational and Legal Risk**

The policies and procedures established by a financial institution for complex structured finance activities should ensure that the legal and reputational risks associated with a transaction, or series of transactions, are identified and evaluated in both the transaction and new product approval processes and effectively and appropriately managed by the institution. A financial institution should have effective policies, procedures and controls for assessing the customer's business objectives for entering into a transaction or series of transactions and the economic substance of the transaction(s), evaluating the appropriateness of the transaction(s), and preventing the financial institution from participating in inappropriate transactions.

Policies should ensure that the customer understands the risk and return profile of the transaction. In instances where the financial institution is designing the transaction and advising the customer, the disclosures to the customer should include an adequate description of the risks in the complex structured finance transaction as well as disclosure of any conflicts of interest associated with the financial institution's participation in the transaction. Policies should also articulate when a proposed transaction requires acknowledgement by the customer that the transaction has been reviewed and approved by higher levels of the customer's management. Notwithstanding a customer's sophistication and structure of a complex structured finance transaction, the financial institution should evaluate the impact a transaction may have on the financial institution's reputation or franchise value.

Policies should outline responsibilities of the sales force, front office, credit and other risk control personnel for analyzing and documenting the customer's objectives and customer-related accounting, regulatory, or tax issues. In addition, a financial institution's policies and procedures should establish criteria or factors for when concerns related to a particular structured finance transaction will necessitate a comprehensive evaluation of the institution's entire relationship with a customer.

Policies should ensure that complex structured finance transactions are reviewed on a consistent basis by the financial institution's legal department and, where

appropriate, by independent outside counsel. In general, the financial institution's legal department should review complex structured finance transactions as part of the approval process. Legal personnel may be assigned to business units or areas where complex structured transactions originate to ensure the legal department's involvement throughout the transaction's development, or financial institutions may assign specific legal personnel to each complex structured finance transaction. Independent monitoring by a risk control group or compliance unit should ensure that all complex structured transactions receive appropriate legal review, including review by outside counsel where appropriate.

Areas for legal review include financial institution permissibility, disclosure by the customer, regulatory capital requirements, the enforceability of any netting and collateral agreements associated with the transaction, suitability or appropriateness assessments, customer assurances, insurance considerations and tax issues. Because transactions may involve multiple counterparties located in different jurisdictions, the financial institution should establish review and documentation procedures that are designed to ensure that each counterparty has the authority to enter into the transaction and that each counterparty's obligations are reduced to legally enforceable contracts. Financial institutions should ensure that any legal reviews are conducted by qualified in-house or outside counsel and that these professionals are provided the documentation and other information needed to properly evaluate the transaction.

Careful evaluations of the consequences of a transaction are particularly important when the transaction is designed to achieve a customer's financial reporting or complex tax objectives. Policies should clearly define the types of circumstances where the approval of transactions or patterns of transactions should be elevated to higher levels of financial institution management for reasons specific to legal or reputational risk. In creating procedures for elevating certain transactions to higher levels, financial institutions should identify the characteristics of those transactions, or series of transactions, that increase reputational and legal risk. Institutions should be conservative when identifying these characteristics. While institutions may differ in the sets of characteristics they identify, the goals should remain the same – to identify the transactions that require additional scrutiny at inception and to ensure that transactions receive a level of review that is commensurate with the legal and reputational risks associated with the transaction. Examples of characteristics that should be considered in determining whether or not a transaction or series of transactions might need additional scrutiny include:

- Transactions with questionable economic substance or business purpose or designed primarily to exploit accounting, regulatory or tax guidelines), (particularly when executed at year end or at the end of a reporting period);
- Transactions that require an equity capital commitment from the financial institution;
- Transactions with terms inconsistent with market norms (e.g., deep “in the money” options, non-standard settlement dates, non-standard forward-rate rolls);

- Transactions using non-standard legal agreements (e.g., customer insists on using its own documents that deviate from market norms);
- Transactions involving multiple obligors or otherwise lacking transparency (e.g. use of SPEs or limited partnerships);
- Transactions with unusual profits or losses or transactions that give rise to compensation that appears disproportionate to the services provided or to the risk assumed by the institution;
- Transactions that raise concerns about how the client will report or disclose the transaction (e.g. derivatives with a funding component, restructuring trades with mark to market losses);
- Transactions with unusually short time horizons or potentially circular transfers of risk (either between the financial institution and customer or between the customer and other related parties);
- Transactions with oral or undocumented agreements, which, if documented, could have material legal, reputational, financial accounting, financial disclosure, or tax implications<sup>6</sup>;
- Transactions that cross multiple geographic or regulatory jurisdictions, making processing and oversight difficult;
- Transactions that cannot be processed via established operations systems; and
- Transactions with significant leverage.

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

- Ensure that staff approving each transaction fully understands the scope of the institution’s relationship with the customer and has evaluated and documented the customer’s business objectives for entering into the transaction, the economic substance of the transaction, and the potential legal and reputational risks to the financial institution;
- Ensure a thorough review and evaluation of whether credit exceptions, accounting issues, rating agency disclosures, law suits against the customer, or other factors expose the financial institution to unwarranted legal or reputational risks;
- Develop and implement effective internal communication procedures to ensure that all financial institution personnel responsible for transaction approval and monitoring receive, and document in a timely manner, complete and accurate information about the transaction, the customer’s purpose(s) for entering into the particular transaction, and the materiality of the transaction to the customer;
- Ensure sufficient time is allowed for a detailed, thorough review of the transaction by the relevant personnel;

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<sup>6</sup> This item is not intended to include traditional, non-binding “comfort” letters 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.

- Ensure that complex structured finance transactions identified as having heightened risks receive a thorough review by senior management for an evaluation of credit, market, operation, legal and reputational risks to the financial institution;
- Ensure that complex structured finance transactions that are determined to present unacceptable risk to the financial institution are declined;
- Ensure that the Board and senior management periodically assess the financial institution's tolerance for risks associated with complex structured finance transactions; and
- Ensure that the institution provides the customer with appropriate information concerning the structure and risks of the transaction, and articulate when a proposed transaction requires acknowledgement of review by higher levels of a customer's management.

### **Accounting and Disclosure by Customers**

As noted above, transactions designed primarily to achieve financial reporting or complex tax objectives may require greater scrutiny due to possible legal and reputational risk implications. For transactions identified as involving elevated risks, the financial institution's procedures should ensure that staff approving the transactions obtain and document complete and accurate information about the customer's proposed accounting treatment of the transaction, financial disclosures relating to the transaction, as well as the customer's objectives for entering into the transaction. The institution's policies should ensure that this information is assessed by appropriate personnel in the approval process and that these personnel consider the information in light of financial, accounting, rating agency disclosure, or other information associated with the transaction that may raise legal or reputational risks for the financial institution.

The financial institution's policies also should address when third party accounting professionals should be engaged to review transactions. Moreover, there may be circumstances where the financial institution or the third-party accounting professionals it engages will wish to communicate directly with the customer's independent auditors to discuss the transaction. Independent monitoring of the approval process (discussed below) should ensure that personnel adhere to established requirements for obtaining a review by third party accountants or communicating with the customer's independent auditor.

In any instance where the financial institution determines that a proposed transaction may result in the customer filing materially misleading financial statements, the financial institution should take appropriate actions. Such actions may include declining to participate in the transaction or conditioning its participation upon the customer making express and accurate disclosures regarding the nature and financial impact of the transaction on the customer's financial condition. The ultimate objective is to take steps to ensure that the financial institution does not participate in an inappropriate transaction. As part of this process, financial institutions should consider seeking representations and warranties from the customer stating the purpose of the transaction,

how the customer will account for the transaction, and that the customer will account for the transaction in accordance with applicable accounting standards, consistently applied.<sup>7</sup>

The financial institution also should develop procedures to address the creation, acquisition, and use of institution and client-sponsored SPEs. When a structured transaction requires the establishment of such an entity, the financial institution should implement a SPE approval process that permits the risk control groups to evaluate the accounting, legal, and tax issues. Effective review may protect the financial institution against accounting, legal, tax, and reputational risks. Financial institutions should also monitor the use of SPEs by providing periodic updates to executive management and maintaining a database of all SPEs created to facilitate structured finance transactions.

### **Documentation Standards**

The documentation that financial institutions use to support complex structured finance transactions is often highly customized and negotiated. Careful generation, collection and retention of documents associated with complex structured finance transactions are important control mechanisms in minimizing legal and credit risks, as well as reducing unwarranted exposures to the financial institution's reputation. Policies and procedures should ensure that transaction documentation is appropriately detailed and transparent for review by all control or approval functions. When in doubt, financial institutions should err on the side of conservatism and retain documents associated with transaction due diligence, approval and monitoring. Financial institutions should maintain comprehensive documentation for all transactions approved, as well as disapproved transactions with controversial elements (e.g. denied in the final stages of approval or due to customer requests for particular terms requiring additional scrutiny).

The documentation policies of a financial institution should seek to ensure that all counterparty obligations are reduced to legally enforceable written contracts. This would include the use of term sheets, confirmations, master agreements, netting agreements, and collateral agreements or comparable documents. An institution should have systems in place to track the status of documentation on a deal-by-deal basis to ensure that counterparties execute and return all necessary contractual documents. The responsibility for drafting transaction documents, or selecting appropriate templates, should be assigned to personnel who can identify legal issues (e.g. enforcing collateral or netting agreements in foreign jurisdictions), and have been given guidance on when to escalate issues involving the drafting process to higher level legal staff or management. Financial institutions that engage in a significant number of complex structured finance transactions may find it beneficial to establish a specialized documentation unit.

The financial institution's documentation standards also should clearly assign accountability and strive for transparency in the approval process and ongoing

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<sup>7</sup> Of course, financial institutions also should ensure that the institution's own accounting for transactions complies with applicable accounting standards, consistently applied.

monitoring of exposures associated with complex structured finance transactions. Such standards should include appropriate guidance on<sup>8</sup>:

- Generation, distribution and retention of documents associated with individual transactions. In addition to standard legal documents, such documentation should include, as appropriate:
  - Deal summary, including a list of deal terms
  - Analysis or opinions (both formal and informal), prepared internally or by third parties, regarding legal considerations, tax and accounting treatments, market viability and regulatory capital requirements for any and all parties
  - Marketing materials and other key documents provided to the customer
  - Internal and external correspondence, including electronic communications, regarding transaction development and due diligence
  - Transaction and credit approvals (including any documentation of actions taken to mitigate initial concerns, such as providing additional client disclosures or changing deal structures)
  - Minutes of critical meetings with the client
  - Disclosures provided to the customer (including side letters or other documents addressing terms or conditions of the transactions), including disclosures of all conflicts of interest and descriptions of the terms of the complex structured finance transactions
  - Acknowledgements received from the customer concerning the accounting, tax, or regulatory implications associated with the transaction
- Generation, distribution and retention of documents such as minutes of meetings of committees and control groups prepared in sufficient detail to indicate issues raised, approval or rejection of a transaction, rationale or factors considered in approving or rejecting a transaction and contingencies or items to be resolved pending final approval. It may be practical to assign a specific coordinator or central location for the maintenance of committee and control group minutes.
- Generation, distribution and retention of information demonstrating final resolution of items still pending at time of transaction approval.
- Generation, distribution and retention of key documents associated with ongoing communications with the customer.
- Generation, distribution and retention of key documents showing the financial institution's monitoring of exposures and periodic assessment of reputational and legal risk considerations.

### **Reporting**

Regardless of the approval structure, the financial institution should define the complex structured finance transaction reporting requirements appropriate for various

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<sup>8</sup> Of course, financial institutions must continue to comply with all applicable laws and regulations governing the making and keeping of records and reports.



levels of management and the Board. Financial institutions should develop and ensure that reports summarizing pending and contemplated complex structured finance transactions are disseminated to appropriate levels of management for their review and further distribution. At a minimum, the financial institution should establish an independent risk function that prepares a periodic summary of trends in complex structured finance transactions and a brief summary of each deal determined to involve heightened risks. In addition, management should establish a process for reporting transactions viewed as possessing higher risk.

### **Independent Monitoring, Analysis, and Compliance with Internal Policies**

The events of recent years evidence the need for a strong compliance function in those financial institutions engaged in complex structured finance transactions. Financial institutions should develop and enforce procedures to conduct periodic independent reviews of complex structured finance business activity to ensure that policies and controls are being implemented effectively and to identify complex structured transactions that may have been executed without proper approvals or which may indicate problematic trends. These reviews should cover all the processes involved in creating, analyzing, offering and marketing complex structured finance products. Procedures should identify departments and personnel responsible for conducting reviews and surveillance. Generally, compliance management oversees this monitoring and analysis, with considerable assistance from personnel in finance and operations.

The establishment of an independent monitoring and analysis program often requires considerable work, as unique reports often need to be set up for specialized products. Elevated monitoring should be directed to those transactions or relationships that the financial institution has identified as presenting heightened legal or reputational risks, based on the factors and considerations discussed above under “Reputational and Legal Risks,” or where the transaction or patterns of transactions pose greater credit or market risk. Such monitoring may include more frequent assessments of customer exposures and elevation of findings to a higher level of management in the financial institution.

Compliance functions often are organized along product lines, and this structure may prove challenging when offering complex structured finance transactions that cross product lines. Practices that may assist financial institutions in establishing proactive compliance functions include, but are not limited to:

- Assigning onsite compliance officers for each traded product or business line and establishing a process for communication across product lines, legal entities, or regions
- Developing comprehensive compliance programs that address responsibilities for risk assessment, identifying and managing conflicts of interest, and require policy implementation, training, monitoring and testing

- Establishing clear policies that govern product and transaction approval, require the pre-approval of higher risk transactions, and define standards for marketing materials
- Conducting periodic reviews of derivatives and complex structured transaction documentation and policy compliance
- Reviewing trading activity to identify off market trades, synthetic funding transactions, unusually profitable trades and customer relationships and trades that present reputational concerns
- Conducting a periodic assessment of the supervision of sales and trading personnel and policy compliance.

## **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. These are all areas of concern with respect to complex structured finance activities. The complexity and relative profitability of these activities may add to the difficulty of analysis and increase the incentives for risk taking. For these reasons, the internal audit department in conducting its review of complex structured finance activities should audit the financial institution's adherence to its own control procedures, and further assess the adequacy of its policies and procedures given the nature of its complex structured finance business.

Effective internal audit coverage of complex structured finance transactions requires a comprehensive independent audit program that is staffed with personnel that have the necessary skills and experience to identify and report on compliance with financial institution policy and procedures. These necessary skills and experience should include an understanding of the nature and risks of structured transactions, as well as a detailed understanding of the institution's policies and procedures. Internal audit should validate that all business lines and individual desks are complying with the financial institution's standards for complex structured finance transactions and appropriately identify any exceptions. This validation should include transaction testing that confirms policy compliance, the existence of proper approvals, the adequacy of documentation, and the integrity of management reporting. Internal audit should have well-articulated procedures for when to expand the scope of audit activities. Further, internal audit should have procedures for reporting audit findings directly to the financial institution's audit committee and senior management of the audited area. Internal audit should implement follow-up procedures to ensure that audit findings have been resolved and the business unit or department has implemented audit recommendations in a timely manner.

In addition, the complexity of the structured finance activities may cause financial institutions to retain outside consultants, accountants, or lawyers to review the structured product area. The retention of such independent expertise may be a prudent method to fully grasp and control the overall risk resulting from such activities. For example, financial institutions may employ external auditors to test the structured transactions approval process and ensure compliance with its policies and procedures. The resulting

reports and memoranda can provide valuable insight to the financial institution in improving its risk controls and oversight.

### **Training**

Appropriate training on the financial institution's policies and procedures for handling complex structured finance transactions is critical. At the inception of a complex structured finance transaction, financial institution personnel should be aware of the required approval process needed for transaction implementation. The financial institution should retain documentation to support the initial and ongoing training of personnel involved in complex structured finance transactions.

### **Summary**

Financial institutions play a critical role in ensuring the integrity of our financial markets. The ability of financial institutions to fulfill this role and operate in a prudent manner depends on a foundation built upon trust and public confidence and compliance with all applicable legal requirements. The regulatory agencies expect financial institutions involved in structured finance transactions to build and implement enhanced risk management and internal controls systems that effectively ensure compliance with the law and control the risks associated with complex structured finance transactions.

Dated: May 13, 2004

/s/ John D. Hawke, Jr.  
Comptroller of the Currency

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Dated: May 12, 2004

By the Office of Thrift Supervision

/s/ James E. Gilleran  
Director

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By order of the Board of the Board of Governors of the Federal Reserve System.

Dated: May 13, 2004

/s/ Jennifer J. Johnson,  
Secretary of the Board

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Dated at Washington, DC, this 11th day of May, 2004.

By order of the Board of Directors.  
Federal Deposit Insurance Corporation.

/s/ Robert E. Feldman  
Executive Secretary

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By the Commission.

/s/ Jonathan G. Katz  
Secretary

May 13, 2004.