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Federal Agencies With Oversight Over Financial Institutions Propose Policy Statement on Structured Finance Transactions

Five federal agencies – the Board of Governors of the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the SEC – have issued for public comment a proposed policy statement (the “Statement”) describing internal controls and risk management procedures that these agencies believe financial institutions that engage in complex structured finance transactions (“CSFTs”) should adopt to identify and address the full range of risks (including legal and reputational risks) associated with CSFTs.

The essence of the Statement is that financial institutions offering CSFTs need to 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 – including structuring, marketing, sales, funding and trading 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.

In addition to addressing reputational risk, the controls are intended to ensure that actions with respect to CSFTs are conducted in accordance with applicable laws and regulations and that CSFTs which may warrant enhanced scrutiny due to factors related specifically to reputational and legal risk can be readily identified.

Overview

The Statement has three parts: an introduction, a section on the definition, and key risks, of CSFTs and a section on guidelines for incorporating CSFTs into existing management procedures, controls and systems. This last section focuses on the role of the board and management in respect of a properly structured risk control framework and outlines the essential elements of the control framework.

Briefly the policies, procedures, controls and systems (the “Policies”) contemplated by the Statement should, among other things:

- define the process that personnel must follow to obtain approval for CSFTs;
- establish a control process for the approval of all "new" CSFT products;

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- ensure that the reputational and legal risks associated with a CSFT are identified and evaluated in both the transaction and new product approval process and appropriately managed by the institution;
- ensure that the customer understands the risk and return profile of a CSFT and notwithstanding the customer's sophistication, the institution evaluates the impact of the CSFT on the institution's reputation;
- ensure that CSFTs are reviewed on a consistent basis by internal and, where appropriate, external counsel;
- ensure that CSFTs that increase legal or reputational risk are subjected to enhanced scrutiny;
- ensure that financial institution staff appropriately reviews and documents the customers' proposed accounting treatment of CSFTs, 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 CSFTs;
- ensure that senior management and the board receive appropriate and timely reports concerning the institution's CSFT activities;
- provide for periodic independent reviews of CSFT activities to ensure that the Policies are being implemented effectively and to identify potential compliance issues;
- ensure effective internal audit coverage of CSFT activities; and
- ensure that personnel receive appropriate training concerning the Policies.

Scope of Coverage

CSFTs encompass a broad array of products with varying levels of complexity. The Statement addresses transactions that usually share several common characteristics, namely they:

- typically result in a final product that is often non-standard and structured to meet the specific financial objectives of a customer;
- 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;
- 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; and
- 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.

Scope of the Risk

The Statement identifies various risks for financial institutions. Financial institutions have been the subject of legal action arising from their involvement in CSFTs that allegedly facilitated the deceptive accounting or financial reporting practices of certain public companies. Legal risk also may arise 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.

Deceptive CSFTs could, for example, lead to liability for violations of the federal securities laws. Liability may be primary, where the financial institution knew of the fraud and was an active participant in the fraudulent scheme. In this instance, the institution might be deemed to have directly violated Section 10(b) and Rule 10b-5 of the Securities Exchange Act. In addition, the institution could be liable, under Section 20(e) of the Exchange Act, for aiding and abetting a public company customer's violation of the Exchange Act, which could include violations of reporting, record-keeping or internal control requirements. An institution could be liable under Rule 13b2-1 of the Exchange Act for *causing* to be falsified any book, record or account subject to the books and records requirements of Section 13(b)(2)(A). Finally, an institution could be subject to cease and desist orders under Section 21C of the Exchange Act for being a *cause* of a violation of the Exchange Act through an "act or omission that the person knew or should have known would contribute to the violation" including a public company customer's reporting, record-keeping or internal control obligations.

CSFTs may also create substantial reputational risk for the institution, which may arise even where the transactions involved are structured to technically comply with existing laws and regulations and accounting standards.

Role of the Board of Directors and Senior Management

The board should establish the financial institution's threshold for the risks associated with CSFT products and ensure that a sufficiently strong risk control framework is in place to guide the actions of the institution's personnel. The board should ensure that the institution has a risk control framework for CSFTs that includes comprehensive policies that address the elements described below.

Under guidance provided by the board, senior management should implement a risk control framework for CSFTs that includes comprehensive policies, defined roles and responsibilities and approval authorities, detailed management reporting, minimum documentation, and ongoing independent monitoring and testing of policy compliance.

The Statement notes that 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, legal and financial control, are involved in the oversight of CSFTs. The goal of such a senior-level risk control committee is to ensure that those CSFTs 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 committee regularly reviews trends in new products and CSFT activity, including overall risk exposures from such transactions, and typically provides final approval of the most complicated or controversial CSFTs.

The board and senior management also should send a message to all employees about the importance of integrity, compliance with the law, and overall good business ethics, which may be implemented through a code of conduct. The institution's culture and procedures should encourage personnel to elevate ethical concerns regarding a complex structured finance transaction or series of transactions to appropriate levels of management. This may require (for institutions not subject to

the Sarbanes-Oxley Act) mechanisms to protect personnel by permitting confidential disclosure in appropriate circumstances. Additionally, the board and senior management should ensure that incentive plans are not structured in a way that encourages employees to cross ethical boundaries when executing CSFTs.

Policies and Procedures

Financial institutions offering CSFTs 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.

The Policies should start with the institution's definition of what constitutes a CSFT and be designed to ensure that the institution appropriately manages its CSFT 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. These policies may be developed specifically for CSFTs or be included in the set of broader policies.

The Policies 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, the Policies should address responsibilities of personnel from sales and trading, relationship management, market risk, credit risk, operations, accounting, legal, compliance, audit and senior management. The Policies should provide a clear framework for the approval and monitoring of CSFTs. 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.

The Policies should ensure that the market, credit, and operational risk associated with individual complex structured transactions are appropriately identified, aggregated, and managed. The Policies should also address the following.

Transaction Approval

The Policies should define the process that personnel must follow to obtain approval for a CSFT. They 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.

The approving authority includes representatives from appropriate control areas that are independent of the transactors. Approving personnel should have appropriate experience and stature to ensure proper consideration of elements or factors that may expose the institution to higher levels of credit, market, operational, legal or reputational risk. The 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

CSFTs also should be incorporated into new product policies. The 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 CSFT 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.

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.

The Policies must 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.

The institution should also 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. 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

Generally

The Policies should ensure that the legal and reputational risks associated with a transaction are identified and evaluated in both the transaction and new product approval processes and effectively and appropriately managed by the institution. The Policies must be effective in 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.

The 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 CSFT as well as disclosure of any conflicts of interest associated with the financial institution's participation in the transaction. The 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 CSFT, the institution should evaluate the impact a transaction may have on the 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, the Policies should establish criteria or factors for when concerns related to a particular CSFT will require a comprehensive evaluation of the institution's entire relationship with a customer.

The Policies should ensure that CSFTs 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 CSFTs 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,
- 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.

Enhanced Scrutiny

Certain transactions that increase reputational and legal risk should be subjected to enhanced scrutiny. Examples of characteristics that should be considered in determining whether or not a transaction or series of transactions might need enhanced 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);
- that require an equity capital commitment from the financial institution;
- with terms inconsistent with market norms (e.g., deep "in the money" options, non-standard settlement dates, non-standard forward-rate rolls);

- using non-standard legal agreements (e.g., customer insists on using its own documents that deviate from market norms);
- involving multiple obligors or otherwise lacking transparency (e.g. use of SPEs or limited partnerships);
- 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;
- 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);
- 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);
- with oral or undocumented agreements, which, if documented, could have material legal, reputational, financial accounting, financial disclosure, or tax implications;
- that cross multiple geographic or regulatory jurisdictions, making processing and oversight difficult;
- that cannot be processed via established operations systems; and
- 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;
- a thorough due diligence 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;
- 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;
- that sufficient time is allowed for a detailed, thorough review of the transaction by the relevant personnel;
- that CSFTs 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;
- that CSFTs that are determined to present unacceptable risk to the financial institution are declined;

- that the board and senior management periodically assess the financial institution's tolerance for risks associated with CSFTs; and
- 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

Generally

For transactions identified as requiring enhanced scrutiny, the Policies 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 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 Policies also should address when third party accounting professionals should be engaged to review transactions.

Potentially Misleading Financial Statements

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. Under the Statement, 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.

Use of SPEs

The Policies should 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 an 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 CSFTs is often highly customized and negotiated. Careful generation, collection and retention of documents associated with CSFTs are important control mechanisms in minimizing legal and credit risks, as well as reducing unwarranted exposures to the financial institution's reputation. Policies 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 caution and retain

documents associated with transaction due diligence, approval and monitoring. 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) should be maintained.

The documentation policies 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. Systems should be 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. 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.

Documentation standards should clearly assign accountability and strive for transparency in the approval process and ongoing monitoring of exposures associated with CSFTs. Such standards should include appropriate guidance on generation, distribution and retention of:

- documents associated with individual transactions, which in addition to standard legal documents, 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 CSFTs; and
 - acknowledgements received from the customer concerning the accounting, tax, or regulatory implications associated with the transaction;
- 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;

- information demonstrating final resolution of items still pending at time of transaction approval;
- key documents associated with ongoing communications with the customer; and
- key documents showing the financial institution's monitoring of exposures and periodic assessment of reputational and legal risk considerations.

Reporting

CSFT reporting requirements should be appropriate for various levels of management and the board. Reports summarizing pending and contemplated CSFTs should be disseminated to appropriate levels of management for their review and further distribution. At a minimum, an independent risk function should prepare a periodic summary of trends in CSFTs 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.

There should be procedures for periodic independent reviews of complex structured finance business activity to ensure that policies and controls are being implemented effectively and to identify CSFTs 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.

Elevated monitoring should be directed to those transactions or relationships that the financial institution has identified as presenting heightened legal or reputational 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 CSFTs that cross product lines. Practices that may facilitate proactive compliance functions include, but are not limited to:

- assigning on-site 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; and
- conducting a periodic assessment of the supervision of sales and trading personnel and policy compliance.

Audit

Effective internal audit coverage of CSFTs 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 standards for CSFTs 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.

Training

Appropriate training on the Policies is critical. At the inception of a CSFT, the personnel involved must be aware of the required approval process needed for transaction implementation. Initial and ongoing training of personnel involved in CSFTs should be documented.

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There are a range of issues presented by this proposed initiative. Is the definition of a CSFT too broad or too vague; are the elements that would trigger heightened scrutiny too broad and likely to sweep in a range of transactions that do not present the sorts of risks that the Statement is intended to cover; is the range of suggested policies and procedures, particularly in respect of customer objectives, intentions and disclosure practices, appropriate; what are the implications of the Statement from a liability standpoint for financial institutions and do the implications vary depending on the type of institution (and the primary regulator)? These and other questions will surface as the comment process unfolds over the next 30 days.

This memorandum provides only a general overview of the proposed statement on complex structured finance transactions and is not intended to provide or constitute legal advice, and no legal or business decision should be based on its contents. Any questions concerning the foregoing should be addressed to:

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