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

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DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. 06-17]

Office of Thrift Supervision

[Docket No. 2006-55]

FEDERAL RESERVE SYSTEM

[Docket No. OP-1254]

FEDERAL DEPOSIT INSURANCE CORPORATION

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-55043; File No. S7-08-06]

Interagency Statement on Sound Practices Concerning

Elevated Risk Complex Structured Finance Activities

AGENCIES: Office of the Comptroller of the Currency, Treasury (“OCC”); Office of Thrift Supervision, Treasury (“OTS”); Board of Governors of the Federal Reserve System (“Board”); Federal Deposit Insurance Corporation (“FDIC”); and Securities and Exchange Commission (“SEC”) (collectively, the “Agencies”).

ACTION: Notice of final interagency statement.

SUMMARY: The Agencies are adopting an Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities (“Final Statement”).

The Final Statement pertains to national banks, state banks, bank holding companies (other than foreign banks), federal and state savings associations, savings and loan holding companies, U.S. branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers (collectively, “financial institutions” or

“institutions”) engaged in complex structured finance transactions (“CSFTs”). In May 2004, the Agencies issued and requested comment on a proposed interagency statement (“Initial Proposed Statement”). After reviewing the comments received on the Initial Proposed Statement, the Agencies in May 2006 issued and requested comment on a revised proposed interagency statement (“Revised Proposed Statement”). The modifications to the Revised Proposed Statement, among other things, made the statement more principles-based and focused on the identification, review and approval process for those CSFTs that may pose heightened levels of legal or reputational risk to the relevant institution (referred to as “elevated risk CSFTs”). After carefully reviewing the comments on the Revised Proposed Statement, the Agencies have adopted the Final Statement with minor modifications designed to clarify, but not alter, the principles set forth in the Revised Proposed Statement. The Final Statement describes some of the internal controls and risk management procedures that may help financial institutions identify, manage, and address the heightened reputational and legal risks that may arise from elevated risk CSFTs. As discussed further below, the Final Statement will not affect or apply to the vast majority of financial institutions, including most small institutions, nor does it create any private rights of action.

EFFECTIVE DATE: The Final Statement is effective upon January 11, 2007.

FOR FURTHER INFORMATION CONTACT:

OCC: Kathryn E. Dick, Deputy Comptroller, Credit and Market Risk, (202) 874-4660; Grace E. Dailey, Deputy Comptroller, Large Bank Supervision, (202) 874-4610; or Ellen

Broadman, Director, Securities and Corporate Practices Division, (202) 874-5210, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

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

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

FDIC: Jason C. Cave, Associate Director, (202) 898-3548; Division of Supervision and Consumer Protection; or Mark G. Flanigan, Counsel, Supervision and Legislation Branch, Legal Division, (202) 898-7426, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.

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

SUPPLEMENTARY INFORMATION:

I. Background

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers, and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, specialized financial conduits that manage pools of assets, and other types of structured finance transactions serve important purposes, such as diversifying risk, allocating cash flows and reducing cost of capital. As a result, structured finance transactions, including the more complex variations of these transactions, now are an essential part of U.S. and international capital markets.

When a financial institution participates in a CSFT, it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, a financial institution involved in a CSFT may face heightened legal or reputational risk if the customer's regulatory, tax or accounting treatment for the CSFT, or disclosures concerning the CSFT in its public filings or financial statements, do not comply with applicable laws, regulations or accounting principles.¹

In some cases, certain CSFTs appear to have been used in illegal schemes that misrepresented the financial condition of public companies to investors and regulatory authorities. After conducting investigations, the OCC, Federal Reserve System and SEC

¹ For a memorandum on the potential liability of a financial institution for securities laws violations arising from participation in a CSFT, see Letter from Annette L. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission, to Richard Spillenkothen and Douglas W. Roeder, dated December 4, 2003 (available at <http://www.federalreserve.gov/boarddocs/srletters/2004/> and <http://www.occ.treas.gov>).

took strong and coordinated civil and administrative enforcement actions against certain financial institutions that engaged in CSFTs that appeared to have been designed or used to shield their customers' true financial health from the public. These actions involved the assessment of significant financial penalties on the institutions and required the institutions to take several measures to strengthen their risk management procedures for CSFTs.² The complex structured finance relationships involving these financial institutions also sparked an investigation by the Permanent Subcommittee on Governmental Affairs of the United States Senate,³ as well as numerous lawsuits by private litigants.

The OCC, Federal Reserve System and SEC also conducted special reviews of several large financial institutions engaged in CSFTs, and the Agencies have focused attention on the CSFT activities of financial institutions in the normal course of the supervisory process. These reviews and activities indicate that many of the large financial institutions engaged in CSFTs have taken meaningful steps in recent years to improve their control infrastructure relating to CSFTs.

II. Initial and Revised Proposed Statements

² See, e.g., In the Matter of Citigroup, Inc., Securities Exchange Act Release No. 48230 (July 28, 2003), Written Agreement by and between Citibank, N.A. and the Office of the Comptroller of the Currency, No. 2003-77 (July 28, 2003) (pertaining to transactions entered into by Citibank, N.A. with Enron Corp.) and Written Agreement by and between Citigroup, Inc. and the Federal Reserve Bank of New York, dated July 28, 2003 (pertaining to transactions involving Citigroup Inc. and its subsidiaries and Enron Corp. and Dynegy Inc.); SEC v. J.P. Morgan Chase, SEC Litigation Release No. 18252 (July 28, 2003) and Written Agreement by and among J.P. Morgan Chase & Co., the Federal Reserve Bank of New York, and the New York State Banking Department, dated July 28, 2003 (pertaining to transactions involving J.P. Morgan Chase & Co. and its subsidiaries and Enron Corp.).

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

To assist financial institutions in identifying, managing, and addressing the risks that may be associated with CSFTs, the Agencies developed and requested public comment on the Initial Proposed Statement.⁴ The Initial Proposed Statement described the types of policies and procedures that a financial institution engaged in CSFTs should have in place to allow the institution to identify, document, evaluate, and control the full range of credit, market, operational, legal, and reputational risks that may arise from CSFTs. The agencies collectively received comments from more than 40 commenters on the Initial Proposed Statement. Although commenters generally supported the Agencies' efforts to describe the types of risk management procedures and internal controls that may help institutions manage the risks associated with CSFTs, virtually all of the commenters recommended changes to the Initial Proposed Statement.

After carefully reviewing the comments on the Initial Proposed Statement, the Agencies issued and requested comment on a Revised Proposed Statement.⁵ The Revised Proposed Statement was modified in numerous respects to clarify the purpose, scope and effect of the statement; make the statement more risk-focused and principles based; and focus the statement on those CSFTs that may pose elevated levels of legal or reputational risk to the relevant institution.⁶

III. Overview of Comments on the Revised Proposed Statement

The Agencies collectively received written comments from 19 commenters on the Revised Proposed Statement, although many commenters submitted identical comments

⁴ See 69 FR 28980, May 19, 2004.

⁵ See 71 FR 28326, May 16, 2006.

⁶ A more detailed summary of the comments on the Initial Proposed Statement, as well as the changes made in response to those comments, is contained in the Federal Register notice accompanying the Revised Proposed Statement (71 FR 28326, 28328-29 (May 16, 2006)).

to multiple Agencies. Commenters included banking organizations, financial services trade associations, and individuals. Commenters generally expressed strong support for the Revised Proposed Statement, including its principles-based structure and focus on elevated risk CSFTs. Many commenters also asserted that the Revised Proposed Statement provides a financial institution appropriate flexibility to develop internal controls and risk management procedures that are tailored to the institution's own business activities and organizational structure.

Several commenters requested that the Agencies clarify or revise the Revised Proposed Statement in certain respects. For example, some commenters asked the Agencies to further streamline the provisions in the statement pertaining to documentation of elevated risk CSFTs, or clarify how the U.S. branches or agencies of foreign banks might implement risk management systems, policies or controls consistent with the statement's principles. In addition, some commenters asked the Agencies to set forth or clarify the legal standards governing the potential liability of financial institutions for CSFTs or provide "safe harbors" from such potential liability. One group of commenters also argued that the Revised Proposed Statement should not be implemented because it allegedly would encourage or condone illegal conduct by financial institutions. The comments received on the Revised Proposed Statement are further discussed below.

IV. Overview of Final Statement

After carefully reviewing the comments on the Revised Proposed Statement, the Agencies have made minor modifications to the Revised Proposed Statement in response to comments and to clarify the principles, scope, and intent of the Final Statement. The Final Statement has been adopted as supervisory guidance by the Board, OCC, FDIC and

OTS and as a policy statement by the SEC. The Agencies will use the Final Statement going forward in reviewing the internal controls and risk management policies, procedures and systems of financial institutions engaged in CSFTs as part of the Agencies' ongoing supervisory process.

The Agencies continue to believe that it is important for a financial institution engaged in CSFTs to have policies and procedures that are designed to allow the institution to effectively manage and address the full range of risks associated with its CSFT activities, including the elevated legal or reputational risks that may arise in connection with certain CSFTs. For this reason, the Final Statement describes the types of risk management principles that the Agencies believe may help a financial institution to identify elevated risk CSFTs and to evaluate, manage, and address these risks within the institution's internal control framework.⁷ These policies and procedures should, among other things, be designed to allow the institution to identify elevated risk CSFTs during its transaction and new product approval processes, and should provide for elevated risk CSFTs to be reviewed by appropriate levels of control and management personnel at the institution, including personnel from control areas that are independent of the business line(s) involved in the transaction.

The Final Statement – like the Revised Proposed Statement – applies to financial institutions that are engaged in CSFT activities and focuses on those CSFTs that may create heightened levels of legal or reputational risks for a participating financial institution. Because CSFTs typically are conducted by a limited number of large

⁷ As noted in the Final Statement, financial institutions are encouraged to refer to other supervisory guidance and materials prepared by the Agencies for further information concerning market, credit and operational risk, as well as for further information on legal and reputational risk, internal audit and internal controls.

financial institutions, the Final Statement will not affect or apply to the vast majority of financial institutions, including most small institutions.

As the Final Statement recognizes, structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities and hedging-type transactions involving “plain vanilla” derivatives or collateralized debt obligations, are familiar to participants in the financial markets, have well-established track records, and typically would not be considered CSFTs for purposes of the Final Statement. Some commenters requested that the Agencies provide a more extensive list of structured finance transactions that typically would not be considered CSFTs. The Agencies note that the types of non-complex transactions listed in the Final Statement are only examples of the types of transactions that typically would not be considered CSFTs and that any list of examples would not, and could not, be all inclusive given the changing nature of the structured finance market. Consistent with the principles-based approach of the Final Statement, the Agencies believe the statement appropriately highlights the hallmarks of a non-complex transaction – *i.e.*, a well established track record and familiarity to participants in the financial markets – that may guide institutions and examiners in considering whether a particular type of transaction should be considered a CSFT now or in the future.

A. Identification, Due Diligence, and Approval Processes for Elevated Risk CSFTs

As noted above, a financial institution should establish and maintain policies, procedures and systems that are designed to identify elevated risk CSFTs as part of the institution's transaction or new product approval processes, and to ensure that transactions or new products identified as elevated risk CSFTs are subject to heightened review.⁸ In general, a financial institution should conduct the level and amount of due diligence for an elevated risk CSFT that is commensurate with the level of risks identified. A financial institution's policies and procedures should provide that CSFTs identified as potentially having elevated legal or reputational risk are reviewed and approved by appropriate levels of management. The Agencies continue to believe that the designated approval process for elevated risk CSFTs should include the institution's representatives from the relevant business line(s) and/or client relationship management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. An institution's policies should provide that new complex structured finance products receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.⁹

⁸ In response to comments, the Agencies have modified the Final Statement to clarify that a U.S. branch or agency of a foreign bank is not necessarily expected to establish or adopt separate U.S.-based risk management structures or policies for its CSFT activities. In addition, the Agencies believe the Final Statement provides U.S. branches and agencies of foreign banks sufficient flexibility to develop controls, risk management and reporting structures, and lines of authority that are consistent with the internal management structure of U.S. branches and agencies. However, the risk management structure and policies used by a U.S. branch or agency, whether adopted or implemented on a group-wide or stand-alone basis, should be effective in allowing the branch or agency to manage the risks associated with its CSFT activities.

⁹ One commenter sought clarification regarding when during the new product approval process a new complex structured finance product should receive the approval of relevant control areas. The Agencies note that the Final Statement is not intended to prevent institutions from engaging in initial or preliminary discussions or negotiations with potential customers about a new complex structured finance product.

The Final Statement – like the Revised Proposed Statement – provides examples of transactions that may warrant additional scrutiny by an institution. These examples include, among other things, transactions that appear to the institution to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year-end or at the end of a reporting period for the customer; or
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

A few commenters contended that the examples of elevated risk CSFTs contained in the Revised Proposed Statement have characteristics that are signals, if not conclusive proof, of fraudulent activity, and recommended that the Agencies inform financial institutions that transactions or products with any of these characteristics should be considered presumptively prohibited. The commenters also argued that the statement encourages or condones illegal conduct by financial institutions. The Agencies believe that CSFTs that initially appear to an institution, during the ordinary course of its new product or transaction approval process, to have one or more of the characteristics identified in the Final Statement should generally be identified as an elevated risk CSFT, and the institution should conduct due diligence for the transaction that is commensurate

However, an institution should obtain the necessary approvals for a new complex structured finance product from appropriate control areas before the institution enters into, or becomes obligated to enter into, a transaction with the customer.

with the level of identified, potential risks. The Agencies, however, do not believe it is appropriate to provide that all transactions initially identified as potentially creating elevated legal or reputational risks for an institution should be considered presumptively prohibited. For example, an institution, after conducting additional due diligence for a transaction initially identified as an elevated risk CSFT, may determine that the transaction does not, in fact, have the characteristics that initially triggered the review. Alternatively, the institution may take steps to address the legal or reputational risks that initially triggered the review. In this regard, the Final Statement expressly provides that, if after evaluating an elevated risk CSFT, a financial institution determines that its participation in the transaction would create significant legal or reputational risks for the institution, the financial institution should take appropriate steps to manage and address these risks. Such steps may include modifying the transaction or conditioning the institution's participation in the transaction upon the receipt of representations or assurances from the customer that reasonably address the heightened risks presented by the transaction.

Importantly, the Final Statement continues to provide that a financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risks to the institution or would result in a violation of applicable laws, regulations or accounting principles.¹⁰ The

¹⁰ Some commenters asked the Agencies to clarify that the Final Statement does not necessarily prevent a financial institution from proceeding with a CSFT simply because there may be some ambiguity in how the transaction might be viewed under the law or applicable accounting principles. The Agencies recognize that in certain circumstances ambiguities may exist as to how the law or accounting principles apply to a CSFT, particularly in light of the inherent complexity and rapidly evolving nature of CSFTs. Nevertheless, as discussed in the Final Statement, a financial institution should maintain strong and effective processes

Final Statement also expressly notes that financial institutions must conduct their activities in accordance with applicable statutes and regulations. The Agencies believe the Final Statement should assist financial institutions engaged in CSFTs in managing the risks associated with these activities and complying with the law, and does not, as some commenters alleged, encourage or condone illegal conduct.

Some commenters also requested that the Agencies enunciate, clarify or modify the legal standards governing the potential liability of a financial institution for participating in a CSFT that is used for fraudulent or illegal purposes. For example, some commenters asked the Agencies to declare that institutions do not have a duty to ensure the accuracy of a client's public filings or accounting. Other commenters asked that the Agencies state that an institution will not be held liable or responsible for a CSFT if the institution has a reasonable degree of confidence that the customer will report or account for the transactions properly. Other commenters expressed concern that the Revised Proposed Statement, or the comments submitted on that document, attempted to alter the current legal standards under which a financial institution may be held liable for fraudulent activity or criminally responsible under the Federal securities law or other laws.

As events in recent years have highlighted, institutions may in certain circumstances bear significant legal or reputational risk from participating in a CSFT. In light of these risks, the Final Statement describes the types of risk management systems and internal controls that may help a financial institution engaged in CSFTs to identify those CSFTs that may pose heightened legal or reputational risk to the institution, and to

and controls designed to determine whether any such ambiguities may create significant legal or reputational risks for the institution and to manage and address those risks as appropriate.

evaluate, manage, and address those risks. Because the Final Statement represents guidance on the part of the Banking Agencies and a policy statement on the part of the SEC, it does not, by itself, establish any legally enforceable requirements or obligations. Moreover, as the Final Statement expressly provides, it does not create any private rights of action, nor does it alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other parties under applicable law. Accordingly, the Agencies do not believe it is appropriate or possible to address in the Final Statement these legal concerns expressed by commenters.

B. Documentation

The Final Statement states that a financial institution should create and collect sufficient documentation to, among other things, verify that the institution's policies and procedures related to elevated risk CSFTs are being followed and allow the internal audit function to monitor compliance with those policies and procedures. The Final Statement also provides that, when an institution's policies and procedures require an elevated risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation that reflect management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the reasons for such action.

Several commenters strongly suggested that the Agencies should eliminate or modify the portions of the statement that provide for a financial institution to maintain certain documentation related to elevated risk CSFTs that are submitted to the institution's senior management for approval (or denial). For example, some commenters argued that institutions should not be required to maintain any documentation for

declined transactions. Other commenters expressed concern that this provision was inconsistent with the current practice of financial institutions, would require financial institutions to create new and potentially extensive documentation to memorialize all aspects of the institution's analytical and decision-making process with respect to an elevated risk CSFT, or would require institutions to create or maintain extensive documentation even for transactions that are approved or rejected by junior staff.

As an initial matter, the Agencies note that the Final Statement's provisions regarding documentation for elevated risk CSFTs submitted to senior management for approval (or disapproval) do not apply to transactions that may be reviewed and acted on by more junior personnel in accordance with the institution's policies and procedures. Rather, these provisions apply only to those elevated risk CSFTs that are identified by the institution as potentially involving the greatest degree of risk to the institution and, for this reason, are required to be reviewed by the institution's senior management. The Agencies believe that it is important for institutions to maintain documentation for this category of elevated risk CSFTs, whether approved or declined, that reflects the factors considered by senior management in taking such action. The Agencies believe this type of documentation may be of significant benefit to the institution and to the Agencies in reviewing the effectiveness of the institution's CSFT-related policies, procedures, and internal controls. However, to help address the commenter's concern about potential burden, the Agencies have modified the Final Statement to recognize that the minutes of an institution's reviewing senior management committee may have the information described and to clarify that the documentation for a transaction should reflect the factors

considered by senior management in taking action, but does not have to detail every aspect of the institution's legal or business analysis of the transaction.¹¹

C. General Risk Management Principles for Elevated Risk CSFTs

The Final Statement – like the Revised Proposed Statement – also describes some of the other key risk management policies and internal controls that financial institutions should have in place for elevated risk CSFTs. For example, the Final Statement provides that the board of directors and senior management of an institution should establish a “tone at the top” through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The Final Statement also describes the types of training, reporting mechanisms, and audit procedures that institutions should have in place with respect to elevated risk CSFTs. The Final Statement also provides that a financial institution should conduct periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated risk CSFTs are being implemented effectively and that elevated risk CSFTs are accurately identified and receive proper approvals.

In response to comments, the Agencies have modified the Final Statement to clarify that the independent reviews conducted by a financial institution may be performed by the institution's audit department or an independent compliance function within the institution. One commenter also asked the Agencies to state that the proper role of an institution's independent review function is only to confirm that the

¹¹ In light of comments, the Agencies have modified the Documentation section of the Statement to clarify that an institution should retain sufficient documentation to establish that it has provided the customer any disclosures concerning an elevated risk CSFT that the institution is otherwise required to provide to the customer.

institution's policies and procedures for elevated risk CSFTs are being followed and that the function should not assess the quality of the decisions made by institution personnel. The Agencies believe that an institution's audit or compliance department should have the flexibility, in appropriate circumstances, to review the decisions made by institution personnel during the review and approval process for elevated risk CSFTs and for this reason have not made the recommended change.

V. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. § 3506; 5 CFR 1320 Appendix A.1), the Agencies reviewed the Final Statement. The Agencies may not conduct or sponsor, and an organization is not required to respond to, this information collection unless it displays a currently valid OMB control number. The Agencies previously determined that certain provisions of the Revised Proposed Statement contained information collection requirements. OMB reviewed and approved the information collections contained in the Revised Proposed Statement for the FDIC, OTS, OCC and SEC; and the Board reviewed the Revised Proposed Statement under the authority delegated to the Board by OMB (5 CFR 1320, Appendix A.1).

OMB control numbers:

OCC: 1557-0229.

OTS: 1550-0111.

FRB: 7100-0311.

FDIC: 3064-0148.

SEC: 3235-0622.

Burden Estimates

OCC

Number of Respondents: 21.

Estimated Time per Response: 25 hours.

Total Estimated Annual Burden: 525 hours.

OTS

Number of Respondents: 5.

Estimated Time per Response: 25 hours.

Total Estimated Annual Burden: 125 hours.

Board

Number of Respondents: 20.

Estimated Time per Response: 25 hours.

Total Estimated Annual Burden: 500 hours.

FDIC

Number of Respondents: 5.

Estimated Time per Response: 25 hours.

Total Estimated Annual Burden: 125 hours.

SEC

Number of Respondents: 5.

Estimated Time per Response: 25 hours.

Total Estimated Annual Burden: 125 hours.

No commenters addressed the Agencies' information collection estimates. The Agencies do not believe that the clarifications included in this Final Statement impact the burden estimates previously developed and approved for these information collections.

The Agencies have a continuing interest in the public's opinions of our collections of information. At any time, comments regarding the burden estimate, or any other aspect of this collection of information, including suggestions for reducing the burden, may be sent to:

OCC: You should direct your comments to:

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

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

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

OTS: Information Collection Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552; send a facsimile transmission to (202) 906-6518; or send an e-mail to infocollection.comments@ots.treas.gov. OTS will post comments and the related index on the OTS Internet site at <http://www.treas.gov>. In addition, interested persons may inspect the comments at the

Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-7755.

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

Board: You may submit comments, identified by FR 4022, by any of the following methods:

- Agency Web site: <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- E-mail: Regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- Fax: (202) 452-3819 or (202) 452-3102.
- Mail: Michelle Long, Federal Reserve Board Clearance Officer (202) 452-3829, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, DC 20551. Telecommunications Device for the Deaf (TDD) users may contact (202) 263-4869, Board of Governors of the Federal Reserve System, Washington, DC 20551.

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

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

- <http://www.FDIC.gov/regulations/laws/federal/propose.html>.
- E-mail: comments@FDIC.gov. Include Complex Structured Financial Transactions, 3064-0148 in the subject line of the message.
- Mail: Steven F. Hanft (202) 898-3907, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- Hand Delivery: Comments may be hand-delivered to the guard station at the rear of the 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m.

SEC: You should direct your comments to: Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, with a copy sent to Nancy M. Morris, Secretary, Securities and

Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090 with reference to File No. S7-08-06.

The Final Statement follows:

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

I. Introduction

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, specialized financial conduits that manage pools of assets and other types of structured finance transactions serve important business purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. As a result, structured finance transactions now are an essential part of U.S. and international capital markets. Financial institutions have played and continue to play an active and important role in the development of structured finance products and markets, including the market for the more complex variations of structured finance products.

When a financial institution participates in a complex structured finance transaction (“CSFT”), it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face

heightened legal or reputational risks due to its involvement in a CSFT. For example, in some circumstances, a financial institution may face heightened legal or reputational risk if a customer's regulatory, tax or accounting treatment for a CSFT, or disclosures to investors concerning the CSFT in the customer's public filings or financial statements, do not comply with applicable laws, regulations or accounting principles. Indeed, in some instances, CSFTs have been used to misrepresent a customer's financial condition to investors, regulatory authorities and others. In these situations, investors have been harmed, and financial institutions have incurred significant legal and reputational exposure. In addition to legal risk, reputational risk poses a significant threat to financial institutions because the nature of their business requires them to maintain the confidence of customers, creditors and the general marketplace.

The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission (the "Agencies") have long expected financial institutions to develop and maintain robust control infrastructures that enable them to identify, evaluate and address the risks associated with their business activities. Financial institutions also must conduct their activities in accordance with applicable statutes and regulations.

II. Scope and Purpose of Statement

The Agencies are issuing this Statement to describe the types of risk management principles that we believe may help a financial institution to identify CSFTs that may pose heightened legal or reputational risks to the institution ("elevated risk CSFTs") and

to evaluate, manage and address these risks within the institution’s internal control framework.¹²

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

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

¹² As used in this Statement, the term “financial institution” or “institution” refers to national banks in the case of the Office of the Comptroller of the Currency; federal and state savings associations and savings and loan holding companies in the case of the Office of Thrift Supervision; state member banks and bank holding companies (other than foreign banking organizations) in the case of the Federal Reserve Board; state nonmember banks in the case of the Federal Deposit Insurance Corporation; and registered broker-dealers and investment advisers in the case of the Securities and Exchange Commission. The U.S. branches and agencies of foreign banks supervised by the Office of the Comptroller, the Federal Reserve Board and the Federal Deposit Insurance Corporation also are considered to be financial institutions for purposes of this Statement.

transactions less frequently. The internal controls and procedures discussed in this Statement are not all inclusive, and, in appropriate circumstances, an institution may find that other controls, policies, or procedures are appropriate in light of its particular CSFT activities.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this Statement draws heavily on controls and procedures that the Agencies previously have found to be effective in assisting a financial institution to manage and control risks and identifies ways in which these controls and procedures can be effectively applied to elevated risk CSFTs. Although this Statement highlights some of the most significant risks associated with elevated risk CSFTs, it is not intended to present a full exposition of all risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory guidance prepared by the Agencies for further information concerning market, credit, operational, legal and reputational risks as well as internal audit and other appropriate internal controls.

This Statement does not create any private rights of action, and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other third parties under applicable law. At the same time, adherence to the principles discussed in this Statement would not necessarily insulate a financial institution from regulatory action or any liability the institution may have to third parties under applicable law.

III. Identification and Review of Elevated Risk Complex Structured Finance Transactions

A financial institution that engages in CSFTs should maintain a set of formal, written, firm-wide policies and procedures that are designed to allow the institution to identify, evaluate, assess, document, and control the full range of credit, market, operational, legal and reputational risks associated with these transactions. These policies may be developed specifically for CSFTs, or included in the set of broader policies governing the institution generally. A financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations and standards of those jurisdictions.¹³

A financial institution's policies and procedures should establish a clear framework for the review and approval of individual CSFTs. These policies and procedures should set forth the responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of CSFTs. Financial institutions may find it helpful to incorporate the review of new CSFTs into their existing new product policies. In this regard, a financial institution should define what constitutes a "new" complex structured finance product and establish a control process for the approval of such new products. In determining whether a CSFT is new, a financial institution may consider a variety of factors, including whether it contains structural or pricing variations from existing products, whether the product is targeted at a new class of customers, whether it is designed to address a new need of customers, whether it raises significant new legal, compliance or

¹³ In the case of U.S. branches and agencies of foreign banks, these policies, including management, review and approval requirements, should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls.

regulatory issues, and whether it or the manner in which it would be offered would materially deviate from standard market practices. An institution's policies should require new complex structured finance products to receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

A. Identifying Elevated Risk CSFTs

As part of its transaction and new product approval controls, a financial institution should establish and maintain policies, procedures and systems to identify elevated risk CSFTs. Because of the potential risks they present to the institution, transactions or new products identified as elevated risk CSFTs should be subject to heightened reviews during the institution's transaction or new product approval processes. Examples of transactions that an institution may determine warrant this additional scrutiny are those that (either individually or collectively) appear to the institution during the ordinary course of its transaction approval or new product approval process to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period for the customer;
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;

- Involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- Involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;¹⁴
- Have material economic terms that are inconsistent with market norms (e.g., deep "in the money" options or historic rate rollovers); or
- Provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market or operational risk assumed by the institution.

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

Financial institutions that structure or market, act as an advisor to a customer regarding, or otherwise play a substantial role in a transaction may have more information concerning the customer's business purpose for the transaction and any

¹⁴ This item is not intended to include traditional, non-binding "comfort" letters or assurances provided to financial institutions in the loan process where, for example, the parent of a loan customer states that the customer (i.e., the parent's subsidiary) is an integral and important part of the parent's operations.

special accounting, tax or financial disclosure issues raised by the transaction than institutions that play a more limited role. Thus, the ability of a financial institution to identify the risks associated with an elevated risk CSFT may differ depending on its role.

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

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

Due Diligence. If a CSFT is identified as an elevated risk CSFT, the institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction with a particular focus on those issues identified as potentially creating heightened levels of legal or reputational risk for the institution. In general, a financial institution should conduct the level and amount of due diligence for an elevated risk CSFT that is commensurate with the level of risks identified. A financial institution that structures or markets an elevated risk CSFT to a customer, or that acts as an advisor to a customer or investors concerning an elevated risk CSFT, may have additional responsibilities under the federal securities laws, the Internal Revenue Code, state fiduciary laws or other laws or regulations and, thus, may have greater legal and reputational risk exposure with respect to an elevated risk CSFT than a financial institution that acts only as a counterparty for the transaction. Accordingly, a financial

institution may need to exercise a higher degree of care in conducting its due diligence when the institution structures or markets an elevated risk CSFT or acts as an advisor concerning such a transaction than when the institution plays a more limited role in the transaction.

To appropriately understand and evaluate the potential legal and reputational risks associated with an elevated risk CSFT that a financial institution has identified, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal, or other professionals. As with any transaction, an institution should obtain satisfactory responses to its material questions and concerns prior to consummation of a transaction.¹⁵

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

Approval Process. A financial institution's policies and procedures should provide that CSFTs identified as having elevated legal or reputational risk are reviewed

¹⁵ Of course, financial institutions also should ensure that their own accounting for transactions complies with applicable accounting standards, consistently applied.

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

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

Some institutions have established a senior management committee that is designed to involve experienced business executives and senior representatives from all of the relevant control functions within the financial institution (including such groups as independent risk management, tax, accounting, policy, legal, compliance, and financial control) in the oversight and approval of those elevated risk CSFTs that are identified by the institution's personnel as requiring senior management review and approval due to the potential risks associated with the transactions. While this type of management committee may not be appropriate for all financial institutions, a financial institution

should establish processes that assist the institution in consistently managing the review and approval of elevated risk CSFTs on a firm-wide basis.¹⁶

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

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

¹⁶ The control processes that a financial institution establishes for CSFTs should take account of, and be consistent with, any informational barriers established by the institution to manage potential conflicts of interest, insider trading or other concerns.

associated with the transactions. In addition, sound documentation practices may help reduce unwarranted exposure to the financial institution's reputation.

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

- Document the material terms of the transaction;
- Enforce the material obligations of the counterparties;
- Confirm that the institution has provided the customer any disclosures concerning the transaction that the institution is otherwise required to provide; and
- Verify that the institution's policies and procedures are being followed and allow the internal audit function to monitor compliance with those policies and procedures.

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

C. Other Risk Management Principles for Elevated Risk CSFTs

General Business Ethics. The board and senior management of a financial institution also should establish a "tone at the top" through both actions and formalized

policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical or legal issues as well as the potential risks to the financial institution that may arise from unethical or illegal behavior. This kind of culture coupled with appropriate procedures should reinforce business-line ownership of risk identification, and encourage personnel to move ethical or legal concerns regarding elevated risk CSFTs to appropriate levels of management. In appropriate circumstances, financial institutions may also need to consider implementing mechanisms to protect personnel by permitting the confidential disclosure of concerns.¹⁷ As in other areas of financial institution management, compensation and incentive plans should be structured, in the context of elevated risk CSFTs, so that they provide personnel with appropriate incentives to have due regard for the legal, ethical and reputational risk interests of the institution.

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

Monitoring Compliance with Internal Policies and Procedures. The events of recent years evidence the need for an effective oversight and review program for elevated risk CSFTs. A financial institution's program should provide for periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating

¹⁷ 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).

to elevated risk CSFTs are being implemented effectively and that elevated risk CSFTs are accurately identified and received proper approvals. These independent reviews should be performed by appropriately qualified audit, compliance or other personnel in a manner consistent with the institution's overall framework for compliance monitoring, which should include consideration of issues such as the independence of reviewing personnel from the business line. Such monitoring may include more frequent assessments of the risk arising from elevated risk CSFTs, both individually and within the context of the overall customer relationship, and the results of this monitoring should be provided to an appropriate level of management in the financial institution.

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

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

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

IV. Conclusion

Structured finance products have become an essential and important part of the U.S. and international capital markets, and financial institutions have played an important role in the development of structured finance markets. In some instances, however, CSFTs have been used to misrepresent a customer's financial condition to investors and others, and financial institutions involved in these transactions have sustained significant legal and reputational harm. In light of the potential legal and reputational risks associated with CSFTs, a financial institution should have effective risk management and internal control systems that are designed to allow the institution to identify elevated risk CSFTs, to evaluate, manage and address the risks arising from such transactions, and to conduct those activities in compliance with applicable law.

Dated: December 12, 2006.

John C. Dugan,
Comptroller of the Currency.

Dated: December 21, 2006.

By the Office of Thrift Supervision.
Scott M. Polakoff,
Deputy Director & Chief Operating Officer

By order of the Board of Governors of the Federal Reserve System, December 20, 2006.

Jennifer J. Johnson,
Secretary of the Board.

Dated at Washington, DC, the 22nd day of December, 2006.

By order of the Federal Deposit Insurance Corporation.
Robert E. Feldman,
Executive Secretary.

Dated: January 5, 2007

By the Securities and Exchange Commission
Nancy M. Morris
Secretary