

Financial Institutions

Regulatory Fallout from Enron: Final Guidance on Complex Structured Finance Transactions

On January 11, 2007, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission (the Agencies) published in the Federal Register a final statement (Statement) on complex structured finance transactions (CSFTs).¹ The Statement applies to national banks, state banks, bank holding companies (other than foreign banking organizations), federal and state savings associations, savings and loan holding companies, US branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers (collectively referred to as financial institutions).

The guidance sets forth the types of internal controls and risk management policies and procedures financial institutions should develop to help them identify, manage and address the heightened legal and reputational risk presented by some CSFTs. As discussed below, a successful implementation of these policies and procedures would require a significant allocation of the financial institution's resources to its legal and compliance infrastructure.

Background

The Agencies first proposed guidance on CSFTs in May 2004 in the aftermath of the Enron scandal and various administrative enforcement actions by the OCC, Federal Reserve and SEC involving financial institutions' activities related to certain CSFTs, particularly those associated with Enron. These transactions also triggered an investigation and report by the US Senate Permanent Subcommittee on Investigations,² as well as significant private civil litigation.

In July 2003, the OCC and the Federal Reserve entered into written agreements with banking organizations that had engaged in CSFTs with Enron. Although different in particular respects, these agreements foreshadowed the Statement by requiring enhanced internal controls and risk

management programs, including policies and procedures, to address complex structured finance transactions.³ They were followed by the proposed guidance on CSFTs in May 2004.

After reviewing numerous comments on the proposal, the Agencies issued a substantially revised proposed statement in May 2006.⁴ Upon reviewing comments on the revised statement, the Agencies made minor changes and then published the final guidance. Going forward, the Agencies will use the Statement as part of their ongoing supervisory process when reviewing institutions' internal controls and risk management policies.

Scope and Purpose of Statement

The purpose of the Statement is to set forth the types of risk management principles the Agencies believe will assist a financial institution in identifying those CSFTs that may pose elevated legal or reputational risks. The Statement also describes ways an institution should evaluate, manage and address such risks within its internal control system.

The Statement points out that structured finance transactions involve a wide range of products, and that most of these vehicles have a "well-established track record" and would not be considered CSFTs for purposes of the Statement. The Agencies provide examples of such "well-established" products, including 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.

The applicability of the Statement is generally limited to large institutions that conduct complex transactions involving heightened legal or reputational risks; therefore, it will not apply to the majority of financial institutions, including most small institutions. If an institution is considering participating in CSFT transactions, however, it

should develop internal controls that are appropriate to its organizational structure and activities regardless of its size. While the Statement sets forth some of the most significant risks associated with CSFTs, institutions are encouraged to use other supervisory guidance when developing their internal control policies. Finally, the Statement makes clear that it does not create any private rights of action, nor does it alter or expand the legal obligations that an institution might have to its customers, shareholders or other third parties.

Policies and Procedures

The Statement provides that institutions should maintain a set of formal, written, firm-wide policies and procedures that are intended to enable them to identify, evaluate, assess, document and control the credit, market, operational, legal and reputational risks associated with their CSFT activities. Under the guidance, institutions may either develop separate policies that apply specifically to CSFTs or include the CSFT-related policies and procedures in a broader set of policies applicable to their structured finance business in general.

Institutions that operate in foreign jurisdictions may amend their policies to comply with the applicable laws of those jurisdictions. US branches and agencies of foreign banks should coordinate these policies with the foreign bank's group-wide policies developed in accordance with the foreign bank's home country supervisor, and such policies should be consistent with the foreign bank's overall internal management structure. In this regard, the Statement clarifies that US branches and agencies have the flexibility to adopt risk management measures and structure policies either on a stand-alone or group-wide basis.

The policies should set forth a clear procedure for the review and approval of CSFTs, including specifying the responsibilities of personnel involved in the origination, structuring, trading, review, approval, documentation, verification and execution of CSFTs. Institutions should define what constitutes a "new" CSFT and establish a process for the approval of such transactions. The Statement provides that an institution's policies should require new CSFTs to be approved by all relevant control areas that are independent of the profit center before being offered to customers.

Identification and Review of Elevated Risk CSFTs

As part of their new product approval policies, institutions should develop procedures that enable them to identify elevated risk CSFTs, which would typically fall within the purview of the institution's working group for approving such products (New Products Committee). These transactions should be subject to heightened review during

the approval process. The Statement provides several examples of characteristics of transactions that might require such special attention:

- Lack of economic substance or business purpose
- Use primarily for questionable accounting, regulatory or tax objectives
- Concerns of material misleading statements in public filings
- Circular transfers of risk
- Oral or undocumented material agreements
- Material economic terms inconsistent with market norms
- Compensation substantially disproportionate with services provided

The initial proposed statement had contained a more extensive outline of such characteristics.⁵ The list was narrowed down in the final Statement in response to comments that many of the characteristics initially described were too broad and would encompass many structured finance products that are not novel and do not present elevated risks.

Due Diligence for Elevated Risk CSFTs

The Statement provides that once a CSFT has been identified as presenting an elevated risk, the institution should proceed carefully and address the risks, paying particular attention to legal, financial and reputational risks. The first step the institution should take is to conduct heightened due diligence that is commensurate with the level of risk presented by the CSFT.

Such diligence might involve obtaining additional information from the customer or specialized advice from accounting, tax, legal or other professionals. The institution should ensure it has satisfactory responses to such questions before consummating a transaction with the customer. The Statement warns that institutions should be careful to analyze the CSFT's potential risks to the institution, independent of the institution's overall customer relationship or the customer's size or sophistication. In addition, an elevated risk CSFT should not be approved solely on the basis that another institution will also participate in the transaction or based on the size or sophistication of the customer. Finally, the Statement recommends that institutions carefully analyze whether it would be prudent to rely on opinions or analyses prepared for the customer regarding significant accounting, tax or legal issues.

Approval Process

According to the Statement, an institution's policies should ensure that elevated risk CSFTs are reviewed and approved by appropriate levels of control and management personnel. The review and approval process should involve individuals from the relevant business lines in addition to control areas that are independent of the business lines. The personnel involved in review and approval should have enough experience and training to be able to evaluate the risks to the institution. Although the Statement does not require that an institution's senior management personnel be responsible for the approval of these transactions, it points out that some institutions have established New Products Committees comprised of executives from the relevant disciplines of the firm.

If, after its evaluation, an institution determines that the transaction presents unacceptable risks, it should decline participation. The Statement also describes other acceptable methods of addressing elevated risks, such as conditioning participation upon receipt of representations or assurances from customers that reasonably address the risks.

Documentation

The Statement recognizes that the documentation used to support CSFTs is often customized for individual transactions and negotiated with each customer. Nevertheless, the Agencies emphasize the importance of careful generation, collection and retention of documents associated with elevated risk CSFTs. The Statement provides that an institution should create and collect sufficient documentation to ensure each of the following:

- Documentation of material terms of the transaction.
- Enforcement of the material obligations of the counterparties.
- Confirmation that the institution has provided the customer with any required disclosures.
- Verification that the institution's policies and procedures are being followed and monitored by internal audit.

The Statement also requires that when elevated risk CSFTs are submitted to senior management for approval, the institution should maintain the transaction-related documentation provided, as well as other documentation that reflects senior management's approval or disapproval, conditions imposed by management and factors considered in making such decisions. In response to comments, the

Agencies explained that the documentation does not have to detail every aspect of the institution's legal or business analysis of the transaction, and they expressly recognized that minutes of an institution's reviewing senior management committee may contain the information the Statement requires.⁶

Other Risk Management Principles

The Statement outlines a number of other, more general risk management principles that should be instituted in order to effectively address elevated risk CSFTs.

- The board and senior management of institutions should establish a "tone at the top" that emphasizes the importance of compliance with the law and good business ethics. Institutions should develop a culture that encourages personnel to bring legal and ethical concerns to the attention of senior management. The Statement suggests that, in some situations, institutions should consider protecting personnel by permitting the confidential reporting of such concerns.
- An institution's policies should provide that the board and management receive appropriate levels of information and reports about the institution's elevated risk CSFTs.
- An institution's policies should provide for periodic independent reviews of its CSFT activities to verify that the elevated risk CSFT policies are being effectively implemented.
- The internal audit department of an institution should regularly audit its adherence to the procedures relating to elevated risk CSFTs.
- An institution should identify personnel in need of specialized training regarding CSFTs and provide training on its policies and procedures.

Practical Implications for Policies and Procedures

The policies and procedures called for by the Statement might be grouped into three general areas:

First, an institution should ensure that it has formal policies and procedures to identify those CSFTs that pose elevated risks. To guide such an identification process, the Agencies have provided significant principles and examples of characteristics that pose such risks, as well as other, more well-established CSFTs that do not.

Second, once an institution has identified a CSFT as posing elevated risks, the institution's policies and procedures must provide for a heightened due diligence and approval process, including the creation, collection and retention of appropriate documentation. The institution should carefully document steps taken along the process.

Third, these specific procedures for elevated risk CSFTs should also be considered in the context of an institution's more general internal controls and procedures, such as those regarding internal audit, training, documentation, and information and review by the board and senior management. In this regard, the institution should consider the following:

- (1) Is the institution's New Products Committee appropriately staffed with qualified accounting, legal, compliance and operational personnel? The vetting process should involve a detailed review of the proposed transaction itself and all the potential liabilities and risks to the institution.
- (2) Is there a sufficient flow of information provided to the institution's New Products Committee? Does the information provided by the "sponsor" of the CSFT clearly outline all of the potential risks and concerns, including disclosure to investors, in the customer's financial statements and public filings?

(3) What should the New Products Committee do when it determines that the proposed CSFT is suspicious? How does the financial institution discharge its regulatory reporting obligations?

(4) Should the New Products Committee review any early unwinds of the previously approved CSFT prior to its originally contemplated maturity? What "red flags" should the financial institution look for once the CSFT has been approved?

Conclusion

The Statement represents a substantial retrenchment from the original regime of heightened scrutiny that the regulators had recommended in 2004. Nevertheless, it suggests that financial institutions engaged in CSFT activities may face the risk of being viewed as "gatekeepers" responsible for reviewing their customers' business dealings and corporate governance as may be warranted. Accordingly, prior to entering into a CSFT, each institution should ensure that its policies and procedures provide clear, specific and practical guidelines.

1. 72 Fed. Reg. 1372 (Jan. 11, 2007).
2. *See Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions*, Report Prepared by the Permanent Subcommittee on Investigations, Committee on Governmental Affairs, United States Senate, S. Rpt. 107-82 (2003).
3. *See e.g.*, Written Agreement by and between Citibank, N.A. and The Office of the Comptroller of the Currency (2003-77) (terminated Dec. 21, 2006); Written Agreement by and between J.P. Morgan Chase & Co., Federal Reserve Bank of New York, and New York State Banking Department (July 28, 2003) (terminated Oct. 25, 2006).
4. 69 Fed. Reg. 28980-01 (May 19, 2004).
5. Some such characteristics that were outlined in the initial proposal included: transactions using non-standard legal-agreements; transactions with unusually short time horizons; transactions with cross multiple geographic or regulatory jurisdictions; and transactions with significant leverage.
6. The initial statement contained a lengthy and more specific list of examples of documentation. In revising the initial proposal, the Agencies explained that they were making the Statement more “principles based” and that they had streamlined and modified the documentation requirements to focus on the proper goals of an institution’s policies and procedures in this area.

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