June 2, 2006

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Transmitted by e-mail

Re: Interagency Statement on Sound Practices Concerning Elevated Risk
Complex Structured Finance Activities (71 Fed. Reg. 28326 (May 16, 2006))
OCC Docket No. 06-06
OTS No. 2006-20
Federal Reserve Docket No. OP-1254
SEC File Number S7-08-06

Dear Staff and Agency Officials:

We are law professors who have just finished reviewing, on behalf of the plaintiff-shareholders, significant record material filed in the Enron civil matter. In the course of our review, we have become familiar with the "complex structured finance transactions" (CSFT) that are the subject of your Proposed Interagency Statement, and that so many leading financial institutions, accountants and lawyers have apparently embraced, notwithstanding the obvious "legal and reputational risks" they pose. We only recently became aware of the Interagency Statement, and upon reviewing the Statement and the Comments on previous drafts, all of which apparently came from the financial services industry,[*] we felt compelled to write to you.

[*] We note that no "institutional investors" offered comments on the 2004 draft. That raises serious questions about current market theory (embedded in certain laws) that asserts that

We think your revised Interagency Statement is a mistake because it can be (and we fear will be) read to encourage and condone illegal conduct. Your agencies should not be parties to such a document. We urge you to withdraw it.

We applaud the instinct that led you to issue your 2004 Interagency Statement on this subject. The 2004 Proposed Statement, whatever its flaws, made it clear that problems exist with current practices surrounding CSFT, and that things have to change. It communicated that a financial institution's reckless indifference to its "customer's" fraudulent purposes is unacceptable. In contrast, the 2006 Proposed Statement, however unintentionally, manages to communicate the opposite.

The 2006 Proposed Statement contains barely a suggestion that anything is wrong with current practices or that CSFT's in a number of cases have skated too close to, or over, the legal line. More important, the Proposed Statement appears to treat one of its key topics – "Identifying Elevated Risk CSFT's" – as a matter almost entirely within the discretion of financial institutions. The Proposed Statement explicitly states that "[a financial] institution may determine" (and therefore need not do so) that certain transactions "warrant . . . additional scrutiny" because those transactions "appear to the institution" to have certain characteristics. The discretion the Proposed Statement seems to give to financial institutions applies regardless of whether the transaction is in the "ordinary course" or involves a "new product."

To make matters worse, the (nonexclusive) list of transaction characteristics that "may . . . warrant additional scrutiny" are all characteristics that are (even in isolation) so indicative of fraud that suggesting through this Policy Statement that an institution might develop a new product (or advise or structure or market or otherwise substantially participate in a transaction) possessing any of these characteristics without "additional scrutiny" or an independent assessment of "legal and reputational risks" is to invite reckless participation in illegal conduct either as a primary fraud-doer or an aider and abettor of another's fraud.

Consider the list of characteristics, which we quote verbatim from the Policy Statement. These include transactions or products that appear to the financial institution to:

> * Lack economic substance or business purpose;
>
> * Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when 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

big institutional investors will act to ensure that at least they have sufficient reliable financial information to make rational investment decisions.

> 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;
>
> * 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.

We find it difficult to imagine how significant transactions with any of these characteristics would not, at a minimum, raise serious questions of illegality. Apparently we are not alone. We searched in vain through the letter-comments submitted in 2004 for any justification for any transaction with any one of these characteristics. We found none. Indeed, what we noticed was that none of the characteristics listed above was even described in the letters submitted by the banks, derivative traders, lawyers, accountants and the financial institution trade associations, the only groups to comment on your proposal. There were comments to the effect that your 2004 list of characteristics was too broad. That concern was apparently answered by cutting the list of example-characteristics to those that were indisputably signals, if not conclusive proof, of fraudulent activity. At the same time, again responding to industry comments, you eliminated all the "shoulds" in the Policy Statement[**] and almost all the detail about what might constitute "additional scrutiny." The result is a Policy Statement that invites the continued creation and marketing of products (as well as other participation in deals) whose sole purpose is the fraudulent manipulation of financial statements.

Given how strongly suggestive of fraudulent purpose each of the items on your 2006 list of characteristics is, any reasonable Policy Statement would, at the very least, make it clear that financial institutions should treat transactions and "products" with any of these characteristics as presumptively prohibited, which is what we read your 2004 Policy Statement to say.[***] But

[**] We recognize that there are "shoulds" in the additional scrutiny section, but because there is no requirement that one get to that stage you have in effect eliminated the "shoulds" from the Policy Statement.

[***] As we mention below, we have no quarrel with the financial institutions' position that the rule include an explicit statement that it creates no private cause of action and that your agencies should not be changing extant law, i.e., should not insulate or create safe harbors for financial institutions from liability. The language in the 2006 Proposed Statement that responds to this concern of the industry is not what troubles us about the revised Statement.

somewhere between 2004 and 2006, what began as a presumptive condemnation of deals with these characteristics morphed into what can (and we believe will) easily be read as permission. That is why the Statement as currently drafted must be withdrawn.

The stated concerns of the financial services industry in their public comments, as we have just noted, was not an explicit defense of deals with any of these characteristics. Rather, there was the ever-present plea for more flexibility in deciding for themselves what to do. But of course, that plea must be read in light of what the leading financial institutions did with the flexibility they enjoyed in their dealings with institutions like Enron. A number of comments mentioned the 3 trillion dollar industry that structured finance has become and warned against hobbling our banks and traders in this global economy. Well, let us hope that 3 trillion dollars is not being wasted on fraudulent devices or deals with the characteristics listed above. We do not mean to suggest it is. Our point is rather that mentioning the economic size of an industry is no justification in itself for failing to regulate the industry's abusive practices. As for global competition, our answer is the same. Banks located in some foreign countries have an easier time money laundering than American banks do, which mean our financial institutions cannot compete for money laundering business. Well, that's the price of having laws. In short, the arguments offered by the industry prove too much by far and thus in the end little at all. Why? Because the specific practices on the list cannot themselves be defended. We write to state that simple truth as much as to make any other point.

One important theme in the comments you received on your 2004 Proposed Statement (we have in mind particularly those of the American Bankers Association) deserves special mention. The banks, traders and their agents emphasized, implicitly and sometimes explicitly, the Supreme Court's decision in *Central Bank*, which held that there was no private cause of action for aiding and abetting securities fraud. The comments suggested you were somehow trying to do an end run around that decision, seeking to change the law, and once again condemn mere aiders and abettors as if *Central Bank* had somehow legalized not just aiding and abetting securities fraud but aiding and abetting tax, mail, wire and all other kinds of frauds too. *Central Bank* did no such thing. It just limited who might sue whom for the wrong of aiding one type of fraud, securities fraud. It "legalized" nothing.

Let us be clear about this point: recklessly aiding and abetting securities fraud is still a crime under federal law, assuming a prosecutor can demonstrate each element beyond a reasonable doubt. Knowingly aiding and abetting securities fraud is also still a civil wrong that may be pursued by the SEC, and there the standard of proof is just more likely than not. Moreover, aiding and abetting other frauds is still illegal and *Central Bank* did nothing to change any of that. What is so troubling about the comments you received on your 2004 proposal is that they proceed as if "primary liability" were all the financial institutions were bound to avoid. The comments speak as if it were the financial institution's right to walk as close to the "primary liability" line as they pleased as long as they did not quite step over it, i.e., as if aiding and abetting fraud were legal. That is how we read all the concern in the comments about lumping together those who develop and market new "products" from those who are mere "counterparties" to transactions that are, on their face,[****] highly suggestive of fraud.

Unfortunately, the 2006 Policy Statement does nothing to discourage the idea that aiding and abetting is somehow legal and indeed encourages financial institutions to continue trying to walk the aiding and abetting/primary violator line. The Statement notes that a financial institution "that acts only as a counterparty" might have lower "legal and reputational risk" than a financial institution that "structures or markets an elevated risk CSFT to a customer." Yes, it is true that there is less legal risk attendant to aiding and abetting because private parties cannot sue and the government, which can sue civilly and prosecute, has limited resources. But it is also true that there is little "legal or reputational risk" for an average citizen who commits tax fraud for the same reasons. We assume, however, you would not think it appropriate to issue a policy statement for taxpayers advising them to consider how small their "legal and reputational risk" would be in deciding whether to file a fraudulent return. How then can it be justified to suggest that banks consider how unlikely they are to face "legal risk" for mere aiding and abetting? In the BLIPS tax shelter controversy, at least one leading financial institution was advised by its lawyers that the legal risks of participating were minimal to none given that the bank itself would not be submitting a false tax return, i.e., it would only be providing the means for another to do so, aiding and abetting. Your Policy Statement, on top of the other problems we have noted, invites precisely that legal analysis.

When Congress decided not to undo *Central Bank*, it was not because it decided that helping others commit fraud was a good thing. It was concern about abusive practices in class action suits. Those commenting on the 2004 Proposed Statement were on solid ground when they asked you to state explicitly that the Statement was not intended to create a private cause of action that Congress had refused itself to create. You did that. Fair enough. But, in sharp contrast to the industry's great respect for *Central Bank*, a legitimate part of our nation's law, is the industry's deliberate disregard and thus disdain and disrespect for laws that are of much more ancient pedigree, laws that prohibit joining (through substantial assistance or agreement–conspiracy) those intent on cheating either other individuals or our national treasury. Apparently, if a class action suit cannot be brought, the financial industry considers that it essentially has free license to do whatever, other laws notwithstanding. But financial institutions, perhaps more than any other players in our economy, need to worry about obeying our laws, particularly our laws against cheating people, not some subset of our laws that may be enforced through private lawsuits.

Let us be frank here: there is something to the industry's attitude. The chance that a major financial institution will be prosecuted for aiding and abetting securities fraud is not great. The legal burden on the government is high (as it is, although for different reasons, even in civil aiding and abetting actions that might be brought by the SEC); the government must also (and

[****] We say "on their face" suggestive of fraud because the 2006 Policy Statement suggestion that additional scrutiny "may" be warranted is triggered when one of the characteristics we listed above is evident "during the *ordinary course* of . . . transaction approval or new product approval." (Emphasis supplied.)

rightly) be concerned with the damage to our economy that the bringing of such a case might precipitate, especially given how large the major financial institutions have become and relatively few there are. But none of that makes it legal to aid and abet; it just means one is not likely to get caught. Moreover, your Policy Statement does not merely invite aiding and abetting. It invites more significant participation in wrongdoing because, as we discussed at the start of this letter, it does not even treat the marketing or developing of new products with the characteristics on this list as presumptively prohibited; and it does not mandate that any serious inquiry aimed at ensuring (and documenting) that such products have non-fraudulent purpose and use be undertaken by those responsible for their creation and active dissemination in the marketplace.

The slim chance of legal consequences for engaging in the illegal conduct of aiding and abetting and the ability to argue in any private suit alleging primary liability that all we did was help provides all the incentive financial institutions need to cross legal lines. Adding fuel to that fire is a very bad idea. Your Policy Statement, in our opinion, does just that by listing characteristics so strongly suggestive of fraud that it is near impossible to imagine how they signal anything else and then requiring that nothing in particular be done to avoid developing, marketing or participating in deals like those you list. We urge that the Policy Statement be withdrawn.

Sincerely,

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