The Bond Market Association
International Swaps and Derivatives Association, Inc.
Securities Industry Association

July 19, 2004

To the Agencies and Persons Named in Appendix A

**Re: Proposed Interagency Statement on Sound Practices Regarding Complex Structured Finance Activities (69 Fed. Reg. 28980 (May 19, 2004))
Office of the Comptroller of the Currency Docket No. 04-12
Federal Reserve System Docket No. OP-1189
Office of Thrift Supervision No. 2004-27
Securities and Exchange Commission Release No. 34-496695; File No. S7-22-04**

The Bond Market Association,[1] the International Swaps and Derivatives Association, Inc.[2] and the Securities Industry Association[3] (collectively, the "Associations") appreciate this opportunity to comment on the Proposed Interagency Statement on Sound Practices Regarding Complex Structured Finance Activities, 69 Fed. Reg. 28980 (May 19, 2004) (the "Proposed Guidance").[4] The Associations' respective members regularly engage in

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[1] The Bond Market Association represents firms and banks that underwrite, distribute and trade in fixed income securities, both domestically and internationally. Its members include all major dealers in U.S. mortgage-backed and asset-backed securities, and other structured securities. More information about the Association is available on its website at www.bondmarket.com.

[2] The International Swaps and Derivatives Association, Inc. ("ISDA") is the global trade association representing participants in the privately negotiated derivatives industry, a business covering swaps and options across all asset classes (interest rate, currency, commodity and energy, credit and equity). ISDA was chartered in 1985, and today numbers over 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions who deal in, as well as leading end-users of, privately negotiated derivatives. The membership includes associated service providers and consultants.

[3] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and non-U.S. markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In 2003, the industry generated an estimated $209 billion in domestic revenue and $278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

[4] The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission are referred to collectively herein as the "Agencies."

transactions coming within the scope of the Proposed Guidance and endorse the risk management objectives underlying the Proposed Guidance.

We have summarized in the immediately following section our principal comments on the Proposed Guidance and have included in the sections that follow a discussion of our more specific comments and recommendations.

OVERVIEW AND SUMMARY

Trillions of dollars in structured finance transactions are executed each year. These transactions, including those that market participants may regard as "complex," provide a wide range of important benefits. They are an important source of capital and liquidity for many capital- and credit-intensive financial products and operations. They are also an important complement to an expanding array of risk management tools. Structured finance transactions have, as a result, become a critical capital market tool for funding operations that support commercial and economic growth.

As acknowledged in the Proposed Guidance, the transactions that gave rise to the concerns underlying the Proposed Guidance, although potentially significant when viewed individually, represent an extremely small fraction of all "complex structured finance transactions."[5] For this reason, it is particularly important that remedial recommendations, such as those contained in the Proposed Guidance, incorporate measured recommendations for control enhancements that strike an appropriate balance between associated costs and benefits.

The Associations are concerned that the additional responsibilities proposed to be imposed on financial institutions under the Proposed Guidance fail to achieve an appropriate balance and could frustrate the accomplishment of the Proposed Guidance's most fundamental objectives. We are also concerned that the Proposed Guidance goes well beyond international supervisory standards and would create obligations of extraterritorial application that would be particularly difficult to satisfy in transactions involving client companies located in non-U.S. jurisdictions.

The Associations believe that these concerns may in some cases be the result of ambiguities in the Proposed Guidance that can largely be addressed by relatively modest, although important, clarifications. In other cases, however, we believe the Proposed Guidance incorporates recommendations that are overly prescriptive or otherwise inappropriate and that should be omitted from any subsequent iteration of the guidance. Unless modified, the Proposed Guidance will result in significant burdens for participants in these markets, distract attention from the risks that may arise in connection with issues of first impression in the future, curtail activity and chill innovation in the markets for structured finance products and create new and unwarranted legal exposures for financial institutions.

We have highlighted immediately below those issues that are of principal concern to the Associations. In light of the scope of the concerns discussed in this letter and the

[5] 69 Fed. Reg. at 28981.

significance of the issues raised by the Proposed Guidance, we urge the Agencies to republish the guidance for public comment prior to the publication of final guidance.

Scope. The scope of complex structured finance transactions subject to heightened review under the Proposed Guidance is ambiguous and could be construed as capturing routine, high volume transactions that do not entail heightened legal or reputational risk, even though they may involve one or more of the characteristics enumerated in the Proposed Guidance as potentially entailing heightened legal or reputational risk. Unless the scope of covered transactions is appropriately clarified or narrowed, the Agencies' guidance will impose unnecessary costs and burdens on financial institutions and other participants in the affected markets - burdens far in excess of the estimates set forth in the preamble to the Proposed Guidance. Of equal concern, if too many transactions meeting specific profiles common to routine transactions are subjected to extensive review processes, the review process itself will be compromised, deflecting attention from those future transactions that may present real and, in particular, novel issues - precisely the issues that review processes should be designed to identify and address.

Principles-based Approach. Sections of the Proposed Guidance are overly prescriptive and do not clearly incorporate the flexibility necessary to accommodate differences among institutions and the range of control processes that individual institutions may elect to implement (or may have implemented) to effectuate the objectives of the Proposed Guidance. A range of control processes can be employed effectively to accomplish the objectives of the Proposed Guidance. These different processes can be better accommodated through a more flexible, principles-based approach that would enable financial institutions to calibrate the degree and level of review to the facts and circumstances of particular transactions or transaction types and otherwise tailor their control processes to reflect their individual circumstances.

Financial Institution Responsibilities. By proposing that a financial institution should be responsible for ensuring that its client company's accounting, disclosure and tax treatment for a complex structured finance transaction is correct, and that the transaction is "appropriate" or "suitable" for the client company, the Proposed Guidance articulates broad new responsibilities for financial institutions. These proposals represent a significant and unwarranted departure from current law. They raise significant practical and policy concerns and are not necessary to accomplish the Proposed Guidance's legal and reputational risk management objectives. A company's compliance with applicable accounting, disclosure and tax requirements is primarily the responsibility of company's management and its advisers, as is the determination whether a particular transaction is appropriate for that company. Although circumstances may arise in which a financial institution has a responsibility to better understand and evaluate its client company's prospective accounting, disclosure or tax treatment, or whether a transaction is appropriate, these circumstances are defined under existing legal standards and the Proposed Guidance should be conformed to those standards.

The failure to incorporate the foregoing clarifications in the Agencies' subsequent guidance could result in significant new legal exposures for financial institutions, exposures that are fundamentally inconsistent with the risk management orientation of the Proposed Guidance and existing supervisory guidance in general. These consequences would be compounded by the Proposed Guidance's numerous admonitions that firms should err on the side of "conservatism" in addressing various issues. In light of the costs and practical obstacles that institutions would confront in attempting to manage these risks, financial institutions or their client companies may well curtail otherwise legitimate complex structured finance activities for which financial institutions cannot practically or cost effectively satisfy the responsibilities proposed. In order for the Proposed Guidance to accomplish its objective of assisting financial institutions in *managing* legal risk, and to avoid *creating* new legal risks for them, any subsequent guidance must clarify the foregoing matters and should additionally clarify that the standards ultimately adopted are for the institutions' protection and are not intended to constitute new legal duties.

DISCUSSION AND RECOMMENDATIONS

Scope of Complex Structured Finance Transactions

The Proposed Guidance recommends that financial institutions individually define the scope of "complex structured finance transactions" under their respective policies and procedures.[6] The Associations agree with this recommendation. The Proposed Guidance also recommends, among other control processes: a control process for the approval of "new" complex structured finance products; a control process for the approval of individual complex structured finance transactions; and a control process for the elevated review of complex structured finance transactions that have been identified as involving potentially heightened legal or reputational risks.[7] The Associations also generally agree with these control objectives.

The Proposed Guidance has given rise to some uncertainty, however, regarding the scope of transactions that should be elevated for heightened scrutiny. Read broadly, the Proposed Guidance could be construed as suggesting that any complex structured finance transaction that involves one or more of twelve identified characteristics (or others specified by a particular institution in its policies) should be elevated to a senior control group for heightened scrutiny.[8] Under this broad reading large numbers and many types of routine transactions would be subjected to elevated review. We do not believe that this result could have been intended by the Agencies.[9]

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6 Id. at 28982.

7 Id. at 28982, 3. The Agencies have noted that firms may include the policies contemplated in the Proposed Guidance in "the set of broader policies governing the institution generally." Id. at 28986. We believe it would be helpful for the Agencies to further clarify that, in so doing, firms would not be obligated to implement definitions and control processes specifically applicable to a defined category of "complex structured finance transactions", but may instead apply policies and procedures of general applicability to such transactions, where such policies and procedures are designed to identify and raise for elevated scrutiny those transactions that present heightened legal or reputational risks.

8 Id. at 28988 ("Examples of characteristics that should be considered in determining whether or not a transaction or series of transactions might need additional scrutiny include. . .").

9 The Proposed Guidance states variously that financial institutions should be "conservative" in determining whether specific complex structured finance transactions should be subject to new product review or heightened scrutiny or in applying other institutional policies, such as document retention policies. We believe this standard, while deceptively appealing, is inappropriate and will exacerbate the concerns regarding the scope of transaction review discussed above. Almost by definition, the proposed standard would, with the benefit of hindsight, subject

Many of the characteristics identified in the Proposed Guidance as potential ‘red flags’ were present in the transactions that were the subject of recent settlements with certain of the Agencies. Many, if not all, of these characteristics, however, are also common in routine transactions that are not particularly complex and that do not, on their face, necessarily raise heightened legal or reputational risks. Read broadly, hundreds of transactions would require elevated review at individual financial institutions on a daily basis, a number that would overwhelm any control process. Whether any one or more of these characteristics in fact presents an issue of potential concern will depend on the transaction context. The suggestion that any one or more of the specified characteristics, alone or in combination, necessitates a specific review by a senior management committee and a full complement of control personnel would be extremely troublesome for a variety of reasons.

The costs and associated personnel resources that would be required to conduct the required reviews would be enormous. A broad range of ordinary course ‘flow’ transactions would be captured. Many routine transactions, because they incorporate common “cross border” elements, would be captured. Most derivatives, which are inherently “leveraged”, would be captured. Significant numbers of transactions involving “SPEs” would be captured because SPE transactions are invariably structured, at a minimum, to ensure tax efficiency and appropriate accounting treatment. New products, for which innovating financial institutions frequently receive premium compensation, would be captured. Similarly, many products that are executed on a daily basis and that either lack standardized documentation entirely (such as bank loans) or routinely involve customization of standardized documentation templates (for perfectly legitimate reasons) would be captured.

We understand that the Agencies have previously considered and resisted suggestions that the Proposed Guidance be limited to transactions involving client companies that are reporting companies under the Securities Exchange Act of 1934. If the Agencies decline to adopt such an approach going forward, we believe the Agencies should ensure that any future guidance is appropriately calibrated for application to those client companies whose size and activities are sufficiently significant that they raise risks of a character and magnitude comparable to the transactions that prompted the Proposed Guidance. Such an approach would be more consistent with the precedents established by the recent settlements.

We particularly see no compelling empirical or policy basis to apply the Proposed Guidance to transactions with individuals in light of the remote likelihood that any such transaction would raise concerns of the type animating the Proposed Guidance. In light of the relatively smaller average size of such transactions and the significant numbers of such transactions, we believe that the benefits of applying the Proposed Guidance to such transactions are substantially outweighed by the attendant costs. Additionally, the issues likely to be raised by such transactions – tax and suitability issues – are, as we discuss below, adequately addressed

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every decision that proves improvident to criticism as inadequately conservative. We recommend that any subsequent guidance instead propose standards promoting strong training in institutional policies and values. Institutional policies should provide for the resolution of any doubt or uncertainty regarding the application of institutional policies to a particular transaction by referral of the issue to more senior or other designated personnel for further guidance.

under current law and supervisory guidance generally and do not warrant product specific guidance.

A process requiring the review of hundreds (even of scores) of transactions daily by senior management would overwhelm the resources of even the largest financial institutions. The resulting burdens would impact not only the affected institutions, but would undoubtedly also adversely impact the efficient operation of the marketplace through associated costs, delays and, in some cases, possible barriers to execution. Such a result cannot be squared with the need to balance the benefits of the Proposed Guidance against its potential costs.

The Agencies have estimated the annual burden associated with the Proposed Guidance at one hundred (100) burden hours per year.[10] The Associations believe that this estimate grossly understates, by orders of magnitude, the time commitment that would be associated with a broad reading of the scope of complex structured finance transactions and associated review processes under the Proposed Guidance. Even a single complex structured finance transaction requiring heightened review could consume in excess of a hundred personnel hours.

The risks associated with subjecting large numbers of routine transactions to an extensive senior review process are not limited to excessive cost and inefficiency or burdens on the marketplace. There is a significant risk that the forest will be lost to the trees. The imposition of repetitive reviews for a succession of transactions that do not raise serious issues will lead to a rote bureaucratic process and will distract focus from issues of first impression that may arise in the future. We believe this is a serious structural hazard that could undermine the most fundamental objectives of the Proposed Guidance.

The Associations therefore request that any subsequent guidance clarify the ambiguity described above by including language along the following lines:[11]

> Although characteristics, such as those enumerated immediately above, should be taken into consideration in evaluating individual transactions, none of the foregoing characteristics, individually or in combination, will necessarily warrant an elevated level of review. The determination whether one or more such characteristics gives rise to heightened legal or reputational risks should be made by those involved in the transaction approval process for the relevant business unit, in consultation with such control personnel as the business unit determines appropriate under the circumstances, based on the facts and circumstances of the particular transaction and the information known to the transactors.

[10] Id. at 28983, 4.

[11] We recommend that the suggested language follow the bulleted paragraphs enumerating the examples of transaction characteristics that firms should consider. See id. at 28988.

Finally, the Proposed Guidance appears to apply whenever a financial institution "offers"[12] a complex structured finance transaction. We note that financial institutions perform many services in connection with structured finance transactions. Some of these, such as underwriting, involve relatively substantial roles. Others, such as paying agent, custody and similar administrative functions, involve relatively insubstantial roles whose connection to the underlying substance of the transaction is more attenuated. The text of the Proposed Guidance does not clearly distinguish between these types of roles. Applying the Proposed Guidance in the context of these less central relationships would be both inequitable and so cost prohibitive that it could deter institutions from performing these roles.[13] Any such consequence would render structured finance transactions even more difficult (or, at a minimum, even more costly) to execute.

Accordingly, we respectfully recommend that the final guidance clarify that the contemplated policies and procedures apply to those transactions in which the institution's role is substantial and active. Where an institution's role is not substantial and active, its internal review should be appropriately limited to consideration of the facts and circumstances of its specific contractual role, absent extraordinary circumstances.

Principles-based Guidance

In numerous contexts, the Proposed Guidance acknowledges that firms will implement the contemplated practices in accordance with their individual internal control frameworks.[14] This is consistent with prevailing principles of supervisory guidance and, we believe, extremely important. The critical objective for any framework of internal controls is that the relevant controls are effective in providing for the identification and evaluation of issues of potential concern. Individual firms must have the flexibility to design their internal controls in a manner consistent with their internal organization, systems and culture. The Proposed Guidance, however, strikes a somewhat uneasy balance between flexibility and prescriptivity. Certain portions of the Proposed Guidance imply a level of prescriptivity that is likely unintended, and is in any event unnecessary and inconsistent with prevailing supervisory guidance. Other portions of the Proposed Guidance appear intentionally to include overly prescriptive recommendations that should be omitted from any subsequent guidance. We believe the Proposed Guidance would benefit generally from a clearer emphasis on a principles-based approach to the development and enhancement of relevant internal controls.

We have identified immediately below some examples of instances in which we believe the Proposed Guidance is or could be construed as overly prescriptive.

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[12] Id. at 28986. Elsewhere, the Proposed Guidance observes that a financial institution assumes a number of risks when it "provides advice on, arranges or actively participates in" a structured finance transaction. Id. at 28984.

[13] An ancillary service provider would, of course, remain responsible for the identification and management of legal and reputational issues arising directly from the nature or terms of the contracted services to be performed by it.

[14] Id. at 28982 ("Financial institutions should consider the Statement in developing and evaluating the institution's risk controls for complex structured finance activities.").

Standing Review Committee. After describing a senior-level committee to approve complex structured finance transactions and to review trends in new product and complex structured transaction activity, the Agencies observe that: "Such a senior-level committee can serve as an important part of an effective control infrastructure for complex structured finance activities."[15]

Although standing committees with a cross-section of control expertise may be one effective approach to conducting product specific reviews, it is not necessary to adopt such a format in order to accomplish the objectives underlying the Proposed Guidance. Alternative approaches may be equally acceptable where they are designed to establish a robust process for identifying and elevating transactions that merit review and require that (1) in connection with such review, those control disciplines that are relevant to the issues that are or may be raised by the transaction are involved and (2) where issues are identified, the resolution of those issues is accomplished with the benefit of the relevant control expertise and by personnel who are independent of or senior to the transacting business unit. As noted elsewhere in the Proposed Guidance, transactions should "receive a level of review that is commensurate with the legal and reputational risks associated with the transaction."[16] Responsibility for final approval may rest with personnel at varying levels of seniority and responsibility, depending on the circumstances.

Definition of Complex Structured Finance Transaction. As noted above, the Proposed Guidance also recommends that firms adopt their own definitions of complex structured finance transactions.[17] While firms may wish to develop mechanisms that are specific to a defined category of complex structured finance transaction, firms should be equally free to develop mechanisms that are either applicable to all transactions, or transactions organized by market sector, business unit, region or other criteria, without any adverse inference being drawn as a result of their doing so. Accordingly, we recommend that the Agencies clarify in any subsequent guidance that a financial institution may individually define the transaction categories that are subject to policies and procedures of the type contemplated by the Proposed Guidance, as well as those characteristics the institution may wish to specify in advance for consideration in determining whether a transaction may raise legal or reputational risks warranting heightened scrutiny.

Areas for Legal Review. The Proposed Guidance identifies a number of subjects as appropriate for legal review, including, among others, disclosure, suitability, capital requirements and tax.[18] Depending on the circumstances, in many cases, these determinations may more appropriately be, and frequently are, made by personnel outside the legal department. Financial institutions should instead be permitted to determine, based on their own circumstances and internal expertise, which internal resources are most appropriate for the evaluation of specific issues.

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[15] Id. at 28986.

[16] Id. at 28987, 8.

[17] Id. at 28986.

[18] Id. at 28987.

External Legal Review. The Proposed Guidance further recommends that an institution's policies and procedures specify when external legal counsel or other experts should be consulted.[19] There are, clearly, categories of transactions, such as public underwritings, for which the retention of outside counsel can be prescribed in institutional policies. At the same time, these are not transactional contexts in which problems have arisen as a result of the failure to retain outside counsel. Unique or unanticipated situations will undoubtedly arise where outside legal counsel or other expert advice is prudent or necessary. However, because these situations are invariably driven by the unique facts and circumstances of a transaction, it will generally not be possible to anticipate and specify those situations, in advance, in written policies and procedures, as recommended in the Proposed Guidance.[20] Instead, it is more realistic for an institution's policies to contemplate recourse to such external resources in appropriate cases where firm personnel identify novel or particularly complex legal or other issues that warrant such review.[21]

To address such situations, an institution's policies might provide that personnel responsible for reviewing an individual complex structured finance transaction determine whether outside counsel should be retained to consider the legal issues then under consideration. We believe that greater specificity than that is not realistic. We therefore recommend that the Agencies clarify that a financial institution should consider specifying in its policies those personnel who may require the retention of outside counsel (or other experts or advisors) in connection with the consideration of legal and reputational risks.

Board Articulation of Risk Tolerance. The Proposed Guidance specifies that the Board of Directors ("Board") of a financial institution should establish and communicate institutional thresholds for the risks associated with complex structured finance transactions.[22] It is not clear to us precisely what the Agencies intend by their references in the Proposed Guidance to Board-specified "thresholds" for the risks associated with structured finance transactions. Unlike credit, market and certain other risks for which quantitative parameters may be established, it would be extremely difficult to articulate "thresholds" for the types of legal and reputational risks discussed in the Proposed Guidance. We suggest instead that the Agencies clarify that the Board should communicate the institutional 'tolerance' for risk - a qualitative, rather than quantitative standard. In addition, we suggest the Agencies clarify that the Board of a financial institution may establish a single legal and reputational risk tolerance standard for application across all product categories.

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[19] Id. at 28987.

[20] The need for external review will, of course, also evolve over time as products mature and internal attorneys gain relevant substantive expertise.

[21] The Proposed Guidance similarly prescribes that policies should articulate when a proposed transaction requires acknowledgment that the transaction has been reviewed and approved by higher levels of the customer's management. This is another example of a determination that does not lend itself to prescriptive standards and would be more effectively addressed on a 'facts and circumstances' basis.

[22] Id. at 28985.

We understand that, in the case of non-U.S. financial institutions, the specification of risk parameters, even at a high level, is frequently assigned to one or more other senior management personnel or committees having the relevant expertise. We do not believe that the Proposed Guidance should prescribe corporate governance standards for non-U.S. financial institutions and we recommend that the Agencies clarify this in any subsequent guidance.

SPE Database. The Proposed Guidance recommends that financial institutions specifically establish a database of SPEs created to facilitate structured finance transactions.[23] It is not clear to us why such a database specific to structured finance transactions is appropriate. Nor is it clear to us why the Proposed Guidance would address an issue of such granularity in a document that recognizes that financial institutions appropriately implement individualized internal controls.[24] Firms already maintain a broad range of business records that enable them to identify specific SPEs that have been created in connection with transactions they have executed. We recommend that the guidance alternatively provide that management should develop policies for the maintenance of records, such as for the identification of SPEs, to the extent appropriate for the management of the legal and reputational risks that may be associated with the use of such vehicles.

Consistent with the foregoing observations, we urge that, in any subsequent guidance, emphasis be given generally to the importance of developing processes reasonably designed to identify and appropriately evaluate issues of potential concern, and to the design of internal controls in order to accomplish specific control objectives, rather than to the use of particular internal control structures that may be described for illustrative purposes in the guidance.

Financial Institution Responsibility

The Associations agree that the internal controls financial institutions adopt should be designed, among other objectives, to:

- protect the institution from engaging in violations of law;
- protect the institution from knowingly providing substantial assistance to a client company that is violating or attempting to violate the law; and
- manage the reputational risks to which a financial institution may be subject, independent of a violation of applicable law by the institution or a client company.

These objectives, however, do not justify an unbounded obligation to investigate and police client company compliance with applicable law or with other standards of conduct.

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[23] Id. at 28989.

[24] We also note that a financial institution would only be in a position to maintain such a database accurately in the case of SPEs that the financial institution controls.

Nor should they be seen as investing a financial institution with the responsibility to investigate whether a transaction is suitable or appropriate for its client company.

Nonetheless, the Proposed Guidance recites variously that financial institutions should:

- obtain and document complete and accurate information[25] regarding a customer's proposed accounting treatment and financial disclosure, as well as the customer's objectives;

- assess the customer's business objectives for entering into a transaction;

- evaluate the appropriateness or suitability of the transaction;

- ensure that the customer understands the risk and return profile of the transaction; and

- analyze and document customer-related accounting, regulatory or tax issues.[26]

Sound practices by financial intermediaries alone will not, and cannot be expected to, ensure the integrity and efficient functioning of these markets. The Proposed Guidance, in our view, skates beyond the boundaries of good policy in suggesting that financial institutions should be responsible, not only for their own compliance with applicable law, but also that of their client companies. Certainly, there are circumstances in which steps such as certain of those outlined above would be appropriate – and possibly even necessary as a matter of law. However, as drafted, the Proposed Guidance inappropriately proposes that these obligations should apply generally. In doing so, the Proposed Guidance would establish new legal duties and responsibilities that could, in turn, significantly *increase* the legal exposure of financial institutions. In this significant respect the Proposed Guidance fundamentally undermines its core objective of specifying practices designed to assist financial institutions in *managing* their legal exposure.

As a matter of good policy and current law, client companies – through their Boards and management – are and should remain primarily responsible for their own compliance with applicable regulatory, accounting and tax requirements. It is even more important that client company management exercise responsibility for determining the appropriateness of transactions, as these determinations involve discretionary qualitative judgments that shareholders specifically look to management to make.

The notion that financial institutions should act as investigators and assume responsibility for monitoring and judging the conduct of client companies (other than in limited contexts discussed below), defies good policy on many levels. It would be highly undesirable and counterproductive if corporate officers regarded their own evaluation of transactions as

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[25] It is unrealistic in our view for the Agencies to impose on a financial institution responsibility for the accuracy and completeness of information provided by a client company, as this recommendation would appear to do.

[26] Id. at 28988.

obviated by, or less urgent as the result of, the evaluation of a "professional" financial institution. In this regard, the Associations feel strongly that the Proposed Guidance would promote a moral hazard. By imposing new responsibilities on financial institutions, the Proposed Guidance would inappropriately dilute the responsibility of corporate management and those professional advisors who have been engaged, and who as a result are effectively positioned, to provide relevant professional advice to the company.

Moreover, financial institutions are *not* accountants or accounting experts and they are *not* tax attorneys or tax accountants. Financial institutions are particularly ill-equipped to assume responsibility for the appropriate tax or accounting treatment that may be applicable to a transaction by a non-U.S. company, especially where local tax or accounting standards may never have contemplated transactions of the type under consideration by a client company. Financial institutions are, in most cases, similarly ill-positioned to make materiality determinations or appropriateness determinations for a client company (or, *a fortiori*, their counterparties in principal transactions) both because they lack the necessary facts and the necessary shareholder mandate.

Client companies generally will not appreciate the type of intrusive inquiry that would be necessitated by an investigation and evaluation of their proposed tax or accounting treatment, or prospective financial disclosure, particularly where the financial institution has not been retained by the company to perform such an evaluation and where there is no *prima facie* basis on which to question the company on these matters. Nor will client companies appreciate the associated direct and indirect expenses associated with such inquiries – costs that should not be underestimated. In many cases, advisors to companies will be reluctant or may refuse to share analyses with a financial institution based on legitimate concerns, such as waiver of the attorney-client privilege. Lack of access to relevant information will likely only be compounded in the context of competitors, non-U.S. companies and advisors.

We discuss immediately below the specific categories identified in the Proposed Guidance for investigation and evaluation by financial institutions.

Tax. The Department of the Treasury and Internal Revenue Service have issued rules requiring taxpayers to disclose transactions with "tax shelter" indicia to the Internal Revenue Service, and requiring material advisors to maintain information about such transactions and to provide that information to the Internal Revenue Service upon request.[27] These rules reflect a substantial effort by those agencies over a period of years to identify the types of transactions that are of interest to them, in a manner that is not unduly burdensome to taxpayers. Financial institutions have made very significant investments to develop procedures and train personnel in order to comply with those rules. We are not aware of any need or basis for the adoption by the Agencies, as financial regulators, of new and inconsistent standards in this area.

Instead, Agency guidance should specify the need for internal controls designed to ensure that financial institutions review transactions in light of their responsibilities under

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[27] 26 C.F.R. § 1.6011-4; 26 C.F.R. § 301.6112-1.

these existing legal standards and that they proceed in compliance with these and similar responsibilities arising under applicable tax law.

Accounting. The evaluation of a client company's prospective accounting treatment raises a number of issues in addition to the more general concerns outlined above. Whether a particular accounting treatment is correct for a given transaction may well depend on facts independent of the economic terms of the transaction, facts that a financial institution may not have readily available to it, or that may hinge on intent – a factor the financial institution will rarely be in a position to evaluate. Additionally, external accountants will frequently refuse or, with similar effect, insist on broad indemnification as a condition to, any discussion (with any person other than an audit client) of proposed accounting treatment, making it difficult or impossible for a financial institution to undertake the responsibilities contemplated in the Proposed Guidance. In recent years, external accountants have, for reasons both practical and legal, become increasingly reluctant or firmly opposed to providing *ad hoc* advice regarding individual transactions to any person other than an audit client. This practical development underscores the difficulty firms would have in implementing the Proposed Guidance, independent of the policy concerns raised by the relevant recommendation.

Accounting decisions also may be finalized only after the execution of a transaction, in connection with the subsequent preparation of periodic financial statements. The predilection among external accountants to reserve accounting judgments until the preparation of periodic financial statements has significantly increased in recent years.

The Proposed Guidance stands in stark contrast to Congress's focus on a company's Board, management, audit committee and external auditors as the appropriate gatekeepers for a company's accounting practices.[28] The approach adopted by Congress is much more effectively designed to place responsibility on those that are both charged with the responsibility, and in a position to discharge the responsibility, to ensure that a client company's accounting (and related financial disclosure) are consistent with applicable law.

Disclosure. Many disclosure determinations, most significantly materiality, can only be made on the basis of facts that go beyond the particular transaction under consideration and, in the majority of cases, beyond information that financial institutions can reasonably expect to be provided by issuers. Disclosure also generally occurs following the execution of a transaction, when the opportunities for involvement by a financial institution are even more limited. As a result, disclosure is and should remain the responsibility of a client company's management, in consultation with the company's accounting, tax and legal advisors.

In circumstances, such as an underwriting, where a financial institution has greater access to relevant facts than it might otherwise have, and disclosure is substantially contemporaneous, there is a well-developed body of practice and law regarding the due diligence obligations, and related legal responsibilities of, the underwriter. We recommend in light of this that the Agencies' guidance instead focus on the need for policies and procedures that are designed to manage the legal and reputational risks that may arise when a financial institution is

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[28] <u>See</u>, <u>e.g.</u>, Sections 201, 202, 204, 301, 401 of the Sarbanes-Oxley Act of 2002.

on notice that a client company may be contemplating a misleading disclosure or that may otherwise arise under existing law in connection with the legal responsibilities of an underwriter or placement agent.

Suitability/appropriateness. The policy considerations cited above underscore the concerns raised by standards that would impose upon a financial institution the responsibility for making difficult qualitative judgments as to whether a particular transaction is appropriate for a particular client company.

The Proposed Guidance appears to use the terms "appropriate" and "suitable" (or their analogues) interchangeably in proposing new responsibilities for financial intermediaries. As a threshold matter, given the unique (and inapposite) meaning given to the term "suitability" under applicable self-regulatory organization rules, we recommend that the Agencies exclude suitability obligations from any subsequent guidance. We note, however, that even in the context of a securities transaction involving a retail customer, a broker-dealer only becomes responsible for the suitability of the transaction in circumstances where the broker-dealer recommends the transaction to its customer. Suitability requirements, of course, also apply to securities transactions with institutional customers. We do not believe it is necessary for the Proposed Guidance to address suitability obligations, however, other than to remind firms of the need to implement policies and procedures designed to manage the legal and reputational risks associated with their existing responsibilities under existing law.

The Proposed Guidance would impose extensive responsibilities on financial institutions that, in most cases, the financial institution will not have been retained to perform, that have not been clearly defined and are unaccompanied by appropriate information. The uncertainty that this will promote is precisely the type of moral hazard that was sought to be avoided both in the Principles and Practices for Wholesale Financial Transactions[29] and in the Voluntary Framework for Supervisory Oversight Published by the Derivatives Policy Group,[30] each of which emphasized the importance of clarifying, as contractual, the nature of the relationship between counterparties in the wholesale markets and clarifying contractually any additional advisory or similar services expected to be performed by financial institution counterparties.

In circumstances where a financial institution is in possession of facts, beyond the mere economic terms of a transaction, that lead it to question whether a complex structured finance transaction is understood by the client company or whether the transaction is appropriate to the client company's objectives, the institution should consider whether it would be desirable, from a legal and reputational risk management perspective, to address these uncertainties

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[29] Principles and Practices for Wholesale Financial Transactions, Feb. 6, 1996 ("Principles and Practices"). The Principles and Practices were prepared by representatives of the Emerging Markets Traders Association, the Foreign Exchange Committee of the Federal Reserve Bank of New York, ISDA, the New York Clearing House Association, the Public Securities Association and SIA. The preparation of the Principles and Practices was coordinated by the Federal Reserve Bank of New York.

[30] Derivatives Policy Group, "A Framework for Voluntary Oversight of the OTC Derivatives Activities of Securities Firm Affiliates to Promote Confidence and Stability in Financial Markets," Mar. 1995.

through discussions at an appropriate level of seniority at the client company. To the extent these uncertainties are not resolved, the financial institution should take them into account in considering whether to proceed with the transaction. This approach would be consistent with existing bank supervisory guidance.[31] Office of the Comptroller of the Currency Banking Circular 277, Risk Management of Financial Derivatives, for example, provides that:

> When the bank believes a particular transaction may not be appropriate for a particular customer, but the customer wishes to proceed, bank management should document its own analysis and the information provided to the customer.

Contrary to the Proposed Guidance, bank supervisors have not previously imposed upon financial institutions the responsibility for determining whether decisions made by a client company are appropriate. Instead, relevant supervisory guidance has consistently, and in our view correctly, focused on whether it is appropriate *for the financial institution* to proceed with a transaction in light of the relevant circumstances. We believe that existing guidance is adequate on this point and that no additional or inconsistent responsibilities should be imposed in the context of the Proposed Guidance.

We also do not agree that the prescriptive customer disclosure requirements described in the Proposed Guidance are warranted or necessary. We believe the existing supervisory guidance in this area is adequate and we recommend that any subsequent guidance instead focus on compliance with existing securities laws and bank supervisory guidance.

General. There are, clearly, circumstances that call for evaluations of the type contemplated by the Proposed Guidance. For example, many financial institutions develop financial products based on general principles and not based on client company- or counterparty-specific information or circumstances. Where a firm is promoting, or has undertaken responsibility to design, a transaction structure specifically tailored to accomplish a particular tax, accounting or regulatory objective, the Associations agree that the firm should in that case, for the management of its own reputational and legal risk, assume responsibility for making its own determination that the transactional structuring objective comports with accounting, tax or legal standards of general application.

Where a financial institution is engaged to design a product tailored specifically to a client company's individual circumstances, the financial institution will, of course, have additional contractual obligations to its client. It will concomitantly, however, be given greater access to the information necessary to discharge those obligations and can more effectively identify the information to which it will need access for its evaluation. Significantly, a financial institution will also be able under those circumstances to appropriately price the services it will be providing and the demands that will be placed on its resources.

Where a firm is on notice that a transaction in which it is a substantial participant may be a vehicle for accomplishing a prohibited or illegal purpose, the firm should assure itself,

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31 See, e.g., Office of the Comptroller of the Currency Banking Circular 277, Risk Management of Financial Derivatives.

for its own protection, and the avoidance of liability under applicable principles of vicarious or secondary liability, that it is not knowingly lending substantial assistance to the accomplishment of such an objective.

Where there is reason for concern, the obstacles noted above that limit a financial institution's access to information or ability to make fully informed evaluations will not justify a decision to proceed in willful ignorance of relevant legal and reputational risks. At the same time, bearing in mind that the "vast majority" of transactions do not involve illegal conduct, it is clear that such obligations should only arise where further inquiry is warranted by the facts and circumstances of a transaction or by other information known to the financial institution and not by the mere existence of a transactional relationship.

Statutory and common law jurisprudence has developed over time defining the circumstances in which secondary actors have a duty of inquiry[32] or potential liability for knowingly providing substantial assistance to a person engaged in a violation of law. This jurisprudence has proved effective. Nothing in the recent settlements or related litigation that gave rise to the Proposed Guidance suggests that existing jurisprudence is inadequate to address the issues presented – even when viewed specifically from the perspective of protection of the public interest. Against this background, we see no empirical or policy justification for using the Proposed Guidance as a vehicle to establish new legal standards inconsistent with existing law.

On the other hand, the adoption of a regulatory standard that renders financial institutions responsible for investigating, detecting and preventing illegal conduct by others will increase the risks and financial exposures faced by financial institutions. Because these risks are, in dollar terms, possibly some of the most significant franchise risks faced by major financial institutions, a substantial increase in the legal exposure of major financial institutions collectively will simultaneously increase risk to the financial system as a whole and should, as a result, be avoided. In any event, the establishment of new legal responsibilities resulting in potential new legal liabilities should not be undertaken in the context of the issuance of Agency supervisory guidance and policy statements.

In light of the foregoing, the Associations urge the Agencies to align their recommended practices for financial institutions more closely to the management of those legal risks that arise under existing law, and associated reputational risks, and clarify that the responsibilities proposed for financial institutions are for the protection of the institution and not an articulation of new legal duties to third parties.

Interagency Coordination; International Considerations

The Associations applaud the Agencies for coordinating with each other in the articulation of relevant supervisory guidance in this important area. Lack of harmonization has many potential adverse consequences, including the fostering of potential competitive disparities that will disadvantage U.S. financial institutions vis-à-vis competitors who are not subject to

[32] Of course, in determining whether the circumstances known to a financial institution make it necessary or appropriate to request further information or assurances, the financial institution should also consider reputational issues in addition to its legal responsibilities.

similar supervisory standards. We similarly encourage the Agencies to coordinate their supervisory activities in this area in order to ensure the application of consistent supervisory standards in connection with the review of institutional compliance with the Agencies' final guidance.

Increasingly, international supervisors recognize the importance of broadly consistent global standards for the supervision of internationally active financial institutions. The Proposed Guidance, however, goes well beyond existing international regulatory standards and market norms. The importance of consistency and the avoidance of anti-competitive effects in the supervision of internationally active financial institutions underscore the need for principles-based U.S. regulatory standards for complex structured finance activities that are capable of being adapted for implementation in other jurisdictions. We believe the Agencies should refrain from imposing significant new substantive obligations on internationally active financial institutions that cannot realistically be expected to be applied outside the U.S. We urge the Agencies to review the Proposed Guidance with a view to maximizing its consistency with emerging international standards and to refrain from imposing significant new substantive obligations on internationally active financial institutions except as part of an emerging global supervisory consensus. To the extent that the Agencies do retain in subsequent guidance standards that are more stringent than emerging global standards, the Agencies should refrain from the application of such standards to transactions involving client companies that are not U.S. reporting companies.

For the avoidance of uncertainty, we further request that the Agencies more clearly define the extraterritorial scope of the Proposed Guidance by clarifying that, in the case of extraterritorial conduct, the Proposed Guidance is limited to the activities of those entities whose extraterritorial conduct is subject to home country consolidated supervisory oversight by one or more of the Agencies.[33]

Documentation Standards

The Proposed Guidance recommends the generation and retention of a broad range of documentation. This would include minutes of committee meetings, minutes of "critical" meetings with client companies, client correspondence, as well as documentation relating to transactions that the institution *does not pursue*.[34]

We believe the proposed documentation practices exceed legitimate business needs and applicable legal standards. Far from representing good "risk management practices" for the institution, the proposed standards appear more aptly designed to effect the deputization of financial institutions as prosecutorial archivists. In some cases, the proposed documentation standards would require the creation and production of documents that could potentially jeopardize the attorney-client privilege that would otherwise attach to the subject matter of the relevant documents.[35]

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[33] Id. at 28986.

[34] Id. at 28989.

There is, in addition, a significant risk that the proposed documentation standards will prove counterproductive. Keeping minutes of client meetings is unlikely to be well received by client companies, and is likely to chill frank discussion. (It is also frequently only in retrospect that it is possible accurately to characterize a client company meeting as a "critical" meeting.) Similarly, detailed minutes of committee deliberations may well chill the discussion of any but the most obvious negative considerations in connection with a prospective transaction. Instead, an institution's policies and procedures should encourage frank and robust discussions. Equally important, we do not think the proposed documentation standards are necessary to accomplish the objectives of the Proposed Guidance. Financial institutions are already subject to a broad range of recordkeeping obligations.

The Associations can identify no *bona fide* risk management objective that is furthered by a requirement that institutions generate and retain documentation of their rejection of specific transactions – regardless of the level at which the determination is made. The proposed standard would require the creation of documentation that, in many instances, would not otherwise exist.

A decision not to proceed with a transaction may be made for a number of reasons in addition to potential legal or reputational concerns. Even where potential issues of concern are identified, a determination not to proceed could well precede any formal consideration of the merits of the relevant issues. Unlike approval, rejection does not require comprehensive evaluation of relevant considerations. Similarly, unlike approvals, rejections do not necessarily occur at defined or mandatory procedural stages. As a result, a determination not to proceed with a transaction is more likely than not to be made without comprehensive consideration of potentially relevant factors and, as a result, relevant records would not be complete and would not comprise a probative resource for reconstruction of relevant deliberations and considerations.

Based on the foregoing, we recommend that any subsequent guidance be limited to recommending the retention of records that document: (1) the material terms of any approved transaction (or whatever other records an institution's policies specify as evidence of the terms of transactions submitted for approval); (2) if the transaction is approved subject to conditions,[36] the relevant conditions and records of their satisfaction; and (3) a record of the agenda for, and final actions taken at, meetings at which complex structured finance transactions are reviewed and acted upon.

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[35] See id. at 28988 (proposing the creation and retention of "key documents" discussing the institution's "assessment of reputational and legal risk considerations….").

[36] In this context, conditions might include contractual provisions, representations or warranties, or legal or other expert opinions or advice, as the relevant decision makers determine appropriate under the circumstances.

Reporting

The Proposed Guidance contemplates the creation of reports for senior management, including the Board, relating to pending and completed complex structured finance transactions.[37] We do not believe it appropriate to report specific pending or completed transactions (individually or as part of a periodic list) either to the Board or to management senior to personnel involved in the approval process, unless those transactions are material to the financial institution itself. Instead, reports prepared for review by the Board and senior management should address the efficacy of the firm's internal controls. These reports should be consistent, in scope and level of detail, with other reports provided to the Board and senior management in connection with their general oversight of the institution's implementation of internal controls.[38]

Training

The Associations agree, as noted in the Proposed Guidance, that training is a critical component of an effective system of internal controls, including with respect to complex structured finance transactions.[39] We believe, however, that by emphasizing the need to familiarize employees with firm "policies and procedures", the Proposed Guidance overemphasizes a prescriptive orientation and misses an opportunity to reinforce two training objectives that, in our view, are most critical to an effective system of controls in this area: (1) education with respect to the firm's institutional philosophy, values and culture, and (2) guidance regarding the importance of identifying facts and circumstances – that ultimately may not appear on any prefabricated "list" – but that may nonetheless raise questions requiring the attention of appropriate management or control personnel or consultation with a client company.

As we have noted, an overly prescriptive approach, designed with specific historical events in focus, may well lock the barn door after the fact and fail to result in processes that will be effective in identifying, in advance, risks arising in the future from issues unrelated to those giving rise to the Proposed Guidance. Firms that elect to adopt a more flexible framework of procedures responsive to the particular considerations raised by a transaction or class of transactions will rely, not only on procedures involving independent control personnel and senior management, but also, to a significant extent, on the values and good judgment of less senior personnel. No rigid system of procedures will effectively substitute for personnel (including front office personnel) who are alert to potential risks - old and new - and who exercise good judgment in a manner consistent with clearly articulated institutional values.

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[37] Id. at 28989.

[38] Of course, the emergence of new risks warranting specific additional Board or senior management guidance should also be the subject of reports to the Board and senior management.

[39] Id. at 28990.

Once again, the Associations appreciate the opportunity to comment on the Proposed Guidance. Please do not hesitate to contact Marjorie E. Gross, Senior Vice President and Regulatory Counsel of The Bond Market Association (tel. no. 646 637-9204), Robert G. Pickel, Executive Director of the International Swaps and Derivatives Association, Inc. (tel. no. 212 901-6020), Gerard J. Quinn, Counsel to the Securities Industry Association (tel. no. 212 618-0507), or Edward J. Rosen of Cleary, Gottlieb, Steen & Hamilton (tel. no. 212 225-2820), outside counsel to the Associations, if you should have any questions or require further information with respect to the foregoing. Representatives of the Associations and their respective members would be pleased to make themselves available to meet with staff of the Agencies in connection with staffs' efforts to finalize the Proposed Guidance.

Respectfully submitted,

The Bond Market Association

By /s/ Micah Green

International Swaps and Derivatives Association, Inc.

By /s/ Robert G. Pickel

Securities Industry Association

By /s/ Marc E. Lackritz

Appendix A

Department of the Treasury
Office of the Comptroller of the Currency
250 E Street, SW
Washington, D.C. 20219

Attention: Public Reference Room, Mail Stop 1-5

Office of Thrift Supervision
1700 G Street, NW
Washington, D.C. 20552

Attention: Regulation Comments, Chief Counsel's Office
No. 2004-27

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Attention: Jennifer J. Johnson, Secretary

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Attention: Robert E. Feldman, Executive Secretary
Comments/OES

Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0609

Attention: Jonathan G. Katz, Secretary