OCC ADVISORY LETTER

Comptroller of the Currency
Administrator of National Banks

Subject: Potential Liability of Financial Institutions for Securities Law Violations Arising from Deceptive Structured Finance Products and Transactions

TO: Chief Executive Officers and Compliance Officers of All National Banks, Department and Division Heads, and All Examining Personnel

PURPOSE

The attached letter dated December 4, 2003, from Annette L. Nazareth, director for the Division of Market Regulation at the U. S. Securities and Exchange Commission (SEC) provides guidance to bank regulators on the potential liability of financial institutions for securities law violations arising from deceptive structured finance products and transactions. Ms. Nazareth's letter includes an internal SEC memorandum that discusses (1) the principal types of securities law violations that can arise from the use of deceptive structured finance products and transactions and (2) the manner in which financial institutions that offer such deceptive products, or participate in such transactions, may be liable for these violations.

As the SEC notes in its memorandum, "The types of securities law violations that may arise from the use of deceptive structured finance products and transactions depend upon the unique facts and circumstances of each case." While not exhaustive, the attached SEC memorandum provides a list of the principal categories of securities laws and violations that arise from common fact patterns, and this list includes antifraud violations, reporting violations, and reporting and internal control violations.

Office of the Comptroller of the Currency examiners should be alert to the factors highlighted in the SEC memorandum when examining structured finance products and transactions at a national bank.

Questions concerning this advisory may be directed to the Securities and Corporate Practices Division at (202) 874-5110, the Treasury and Market Risk Division at (202) 874-5670, or the appropriate supervisory office.

Emory W. Rushton
Senior Deputy Comptroller and Chief National Bank Examiner

Douglas W. Roeder
Senior Deputy Comptroller for Large Bank Supervision

Attachment – Letter to Douglas W. Roeder, senior deputy comptroller for Large Bank Supervision, and Richard Spillenkothen, director of the Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, from Annette L. Nazareth, director for the Division of Market Regulation, SEC, December 4, 2003

http://www.occ.treas.gov/ftp/advisory/2004-5a.pdf

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

December 4, 2003

Richard Spillenkothen
Director
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
20th and C Streets, NW
Mail Stop 177
Washington, DC 20551

Douglas W. Roeder
Senior Deputy Comptroller
Large Bank Supervision
Office of the Comptroller of the Currency
250 E Street, SW
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Washington, DC 20219

Re: Guidance on the Potential Liability of Financial Institutions for Securities Law Violations Arising from Deceptive Structured Finance Products and Transactions

Dear Messrs. Spillenkothen and Roeder:

As you know, on January 2, 2003, the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs issued a report examining the role of financial institutions in the collapse of Enron Corporation. The report recommended several actions that the Federal Reserve, Office of the Comptroller of the Currency, and Securities and Exchange Commission could take to stop banks and securities firms from helping U.S. companies engage in deceptive structured finance transactions. The Subcommittee asked the Federal Reserve, OCC, and SEC for a response to the report's recommendations.

In a joint response, the SEC indicated, among other things, that it would provide guidance to the banking regulators explaining the statutory bases for potential liability of secondary actors, including primary and aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934. The enclosed memorandum from the SEC's Office of the General Counsel is intended to provide such guidance. The memorandum discusses: (1) the principal types of securities law violations that can arise from the use of deceptive structured finance products and transactions; and (2) the manner in which financial institutions that offer such deceptive products, or participate in such transactions, may be liable for these violations.

I hope that this guidance will be useful to you. If you have any questions regarding this matter, please do not hesitate to contact me at (202) 942-0090.

Sincerely,

Annette L. Nazareth

Annette L. Nazareth
Director

Enclosure

cc: The Honorable Susan M. Collins
The Honorable Joseph I. Lieberman
The Honorable Norm Coleman
The Honorable Carl Levin

MEMORANDUM

December 4, 2003

TO: Division of Market Regulation
Annette Nazareth

FROM: Office of the General Counsel
Stephen Jung SMJ
Michael Bloise

RE: Guidance on the Potential Liability of Financial Institutions for Securities Law Violations Arising from Deceptive Structured Finance Products and Transactions

A. INTRODUCTION

On January 2, 2003, the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs issued a report examining the role of financial institutions in the collapse of Enron Corporation. The report recommended several actions that the Federal Reserve, Office of the Comptroller of the Currency ("OCC"), and Securities and Exchange Commission ("SEC") could take to stop banks and securities firms from helping U.S. companies engage in deceptive structured finance transactions. Among the recommendations, the report suggested that the SEC provide banking regulators with a statement that it is the SEC's policy to take enforcement action against a financial institution that offers a deceptive financial product to, or participates in deceptive financial transactions with, a U.S. publicly traded company, thereby aiding and abetting that company's inclusion of materially false or misleading information in its financial statements or reports.

The Subcommittee asked the Federal Reserve, OCC, and SEC to respond to the report's recommendations. In a joint response, the SEC indicated, among other things, that it would provide a letter to the banking regulators explaining the statutory bases for potential liability of secondary actors, including primary and aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"). The purpose of this memorandum is to provide such guidance, including: (1) the principal types of securities law violations that can arise from the use of deceptive structured finance products and transactions; and (2) the manner in which financial institutions that offer such deceptive products, or participate in such transactions, may be liable for these violations.

B. DISCUSSION

1. Principal Securities Law Violations Arising from Deceptive Structured Finance Products and Transactions

The types of securities law violations that may arise from the use of deceptive structured finance products and transactions depend upon the unique facts and circumstances of each case. The following discussion highlights the principal categories of securities law violations that arise from common fact patterns, and is not intended to be an exhaustive list.

a. Antifraud Violations

Deceptive structured finance transactions may give rise to violations of the antifraud provisions of the federal securities laws - particularly Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act of 1933 ("Securities Act"). Section 10(b) of the Exchange Act and Rule 10b-5 thereunder make it unlawful for any person, in connection with the purchase or sale of any security, to employ any device, scheme, or artifice to defraud; to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. Section 17(a) of the Securities Act prohibits similar misconduct in the offer or sale of any securities.

To prove an antifraud violation based upon a misstatement or omission of a fact, the fact must be material. Basic, Inc. v. Levinson, 485 U.S. 224, 233 (1988); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). A fact is material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. Basic, 485 U.S. at 231-32; TSC Industries, 426 U.S. at 449. For example, misrepresentations concerning a firm's financial resources or its ability to meet its obligations may be material. SEC v. Championship Sports Management, Inc., 599 F. Supp. 527, 532-33 (S.D.N.Y. 1984); SEC v. North Am. Research & Development Corp., 375 F. Supp. 465, 470 (S.D.N.Y. 1974), aff'd, 511 F.2d 1217 (2d Cir.), cert. denied sub nom., White v. SEC, 423 U.S. 830 (1975).

To prove a violation of Section 10(b) and Rule 10b-5, the SEC also must prove that the defendant acted with scienter. Aaron v. SEC, 446 U.S. 680, 691 (1980). Scienter is established by showing "a mental state embracing intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n. 12 (1976). A number of U.S. Courts of Appeals also have held that recklessness satisfies the scienter requirement. See, e.g., Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc). A showing of scienter also is necessary to establish a violation of Section 17(a)(1) of the Securities Act, but a showing of negligence is sufficient to establish a violation of Sections 17(a)(2) or (3) of the Securities Act. Aaron, 446 U.S. at 695-6.

The "in connection with" requirement of Section 10(b) requires only that there be a nexus or relationship between the fraud and a securities transaction. One way that requirement can be satisfied is by showing that there exists a reasonable expectation that publicly disseminated statements will cause reasonable investors to buy or sell securities in reliance thereon, regardless of the existence of contemporaneous transactions by or on behalf of the violator. SEC v. Savoy Industries, Inc., 587 F.2d 1149, 1171 (D.C. Cir. 1978), citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860-61 (2nd Cir. 1968), cert. denied, 394 U.S. 976 (1969). Thus, a company's issuance of false and misleading statements may be "in connection with" the purchase or sale of securities irrespective of whether the company is then engaged in an offering of securities. See SEC v. Jakubowski, 150 F.2d 675, 680 (7th Cir. 1998), cert. denied, 525 U.S. 1103 (1999) (misrepresentations satisfy "in connection with" requirement if they influence an investment decision).

There are a number of ways in which deceptive structured finance transactions may violate the antifraud provisions. For example, an issuer may falsely characterize the nature of the transaction in a press release, shareholder report, or on the Internet. An issuer also may deceive investors by including materially misleading statements relating to a structured finance transaction in the reports that it files with the SEC. These might include an issuer's financial statements that reflect inflated earnings or cash flow, or reduced debt, as a result of a structured finance transaction. As discussed below, a financial institution could be primarily or secondarily liable for its role in such a fraud.

b. Reporting Violations

Section 13(a) of the Exchange Act requires all issuers whose securities are registered with the SEC to file periodic reports containing such information as the SEC shall prescribe by its rules and regulations. Pursuant to Section 13(a), the SEC promulgated Rules 13a-1 and 13a-13, which require issuers to file with the SEC annual and quarterly reports, respectively. Rule 13a-11 further requires issuers to file current reports (on Form 8-K) upon the occurrence of certain events. Financial statements incorporated in any of these filings must comply with Regulation S-X, which in turn requires conformity with Generally Accepted Accounting Principals ("GAAP").

Courts uniformly have held that "the requirement that an issuer file reports under Section 13(a) embodies the requirement that such reports be true and correct." SEC v. Savoy Industries, 587 F.2d 1149, 1167 (D.C. Cir. 1978). In addition, Rule 12b-20 requires that such reports contain any additional information necessary to ensure that the required statements in the reports are not, under the circumstances, materially misleading. Thus, the filing of a periodic report that contains materially false and misleading statements or that omits material facts necessary to make the statements therein not misleading constitutes a violation of the reporting provisions of the Exchange Act. No showing of scienter is required to establish a violation of the reporting provisions. Savoy Industries, 587 F.2d at 1167.

Issuers that include inaccurate or misleading information concerning structured finance transactions in reports filed with the SEC may violate the reporting provisions. Reporting violations often occur in connection with financial fraud cases. In such cases, an issuer may conceal the true nature of a fraudulent transaction through false financial statements in SEC reports. In the course of working with an issuer, a financial institution could aid and abet or cause the issuer's violation.

c. Recordkeeping and Internal Controls Violations

Section 13(b)(2)(A) of the Exchange Act requires issuers to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions of the issuer. Section 13(b)(2)(B) further requires issuers to devise and maintain an adequate system of internal accounting controls. Scienter is not required to establish a violation of Section 13(b)(2)(A) or (B). SEC v. Tiffany Industries Inc., 535 F. Supp. 1160 (E.D. Mo. 1982).

Rule 13b2-1 prohibits, directly or indirectly, falsifying or causing to be falsified, any book, record, or account subject to Section 13(b)(2)(A) of the Exchange Act. Rule 13b2-2 prohibits an officer or director of an issuer from making materially false statements or omitting to state a material fact necessary to make statements made not misleading to an accountant in connection with an audit or in connection with the preparation of any document to be filed with the SEC.

Section 13(b)(5) of the Exchange Act prohibits any person from knowingly circumventing or failing to implement a system of internal accounting controls or knowingly falsifying any book, record, or account required to be made and kept by Section 13(b)(2) of the Exchange Act. Liability under Section 13(b)(5) requires a showing of scienter. SEC v. PictureTel Corp. et al., Exchange Act Rel. No. 45665, 2002 SEC LEXIS 799 (March 28, 2002).

Like reporting violations, recordkeeping and internal controls violations often arise as a result of financial fraud. An issuer that engages in a deceptive structured finance transaction may take steps to conceal the fraud, including manipulating books and records and bypassing internal controls. As discussed below, liability may accrue to a financial institution for an issuer's violation of these provisions.

2. Potential Liability of Financial Institutions for Securities Law Violations Arising from Deceptive Structured Finance Products and Transactions

a. Primary Liability

Depending upon the specific facts at issue, it is possible for a financial institution to have primary liability for securities fraud for offering deceptive structured finance products to, or participating in deceptive structured finance transactions with, an issuer. There is precedent to support the imposition of primary liability both on persons who make fraudulent misrepresentations and on those who know of fraud and assist in its perpetration. See, e.g., SEC v. U.S. Environmental Inc., 155 F.3d 107, 112 (2nd Cir. 1998), cert. denied, 119 S.Ct. 1755 (1999) ("Like lawyers, accountants, and banks who engage in fraudulent or deceptive practices at their clients' direction, [the defendant] is a primary violator despite the fact that someone else directed the market manipulation scheme"); and SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1471 (2nd Cir. 1996) (finding a defendant liable as a primary violator of the antifraud provisions because he knew of fraud and participated in the fraudulent scheme).

Courts in some private securities cases, however, have applied different standards to determine whether a defendant may be primarily liable for violating Section 10(b). Compare Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) (limiting primary liability to those who "make" material misstatements in their own name); with Carley Capital Group v. Deloitte & Touche, LLP, 27 F.Supp.2d 1324, 1334 (N.D. Ga. 1998) (finding primary liability for "a secondary actor [who] acting alone or with others, creates a misrepresentation even if the misrepresentation is not publicly attributed to it"); and Howard v. Everex Systems, Inc., 228 F.3d 1057, 1061 n. 5 (9th Cir. 2000) citing In re Software Toolworks, Inc., 50 F.3d 615, 628-39 (9th Cir. 1994) ("substantial participation or intricate involvement" in the preparation of fraudulent statements is grounds for primary liability even if the person did not actually make the statements).

A recent enforcement action illustrates the potential primary liability of a financial institution for an issuer's financial fraud. In September 2003, the SEC settled fraud charges against American International Group, Inc. arising from an accounting fraud committed at Brightpoint, Inc. See Litigation Release No. 18340, 2003 SEC LEXIS 2165 (September 11, 2003). The SEC alleged that AIG developed and marketed a so-called "non-traditional" insurance product for the stated purpose of "income statement smoothing," *i.e.*, enabling a public reporting company to spread the recognition of known and quantified one-time losses over several future reporting periods. The intent was to create the appearance of "insurance." Specifically, AIG agreed to make it appear that the "insured" (Brightpoint) was paying premiums in return for an assumption of risk by AIG. In fact, Brightpoint was merely depositing cash with AIG that AIG refunded to Brightpoint.

AIG issued the purported insurance policy to Brightpoint for the purpose of assisting Brightpoint to conceal $11.9 million in losses that Brightpoint sustained in 1998. As a result, Brightpoint's 1998 financial statements overstated the company's actual net income before taxes by 61 percent.

AIG agreed to consent to a Commission order finding that it violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and was a cause of Brightpoint's chief accounting officer's violation of Exchange Act Rule 13b2-2. AIG was ordered to cease and desist from future violations; disgorge, with prejudgment interest, the fee it charged to Brightpoint for putting the "policy" together; and retain an independent consultant to make binding recommendations concerning AIG's internal controls. In addition, AIG agreed to settle a related civil action filed by the SEC by paying a $10 million penalty.

b. Aiding and Abetting Liability

Section 20(e) of the Exchange Act provides for aiding and abetting liability for any person who knowingly provides substantial assistance to another person in violation of any Exchange Act provision, or any rule thereunder. The scope of Section 20(e) liability is very broad, and its application to "any person" includes a financial institution that offers a deceptive structured finance product or participates in a deceptive structured finance transaction. The use of "any Exchange Act provision" as a predicate offense for Section 20(e) liability means that a financial institution participating in a deceptive structured transaction can be liable for aiding and abetting an issuer's reporting, recordkeeping, or internal controls violations. Proving an aiding and abetting case generally requires a showing of three elements: (1) a primary violation of the securities laws by another; (2) substantial assistance by the alleged aider and abettor in the violation; and (3) the necessary scienter on the part of the aider and abettor, *i.e.*, knowing or reckless assistance. Graham v. SEC, 222 F.3d 994, 1000 (D.C. Cir. 2000).

A recent enforcement action illustrates the type of conduct that can result in aiding and abetting liability for a financial institution that participates in deceptive structured finance transactions. In July 2003, the SEC initiated and simultaneously settled a civil action against J.P. Morgan Chase & Co., in which the SEC charged the bank with aiding and abetting Enron Corp.'s securities fraud. See Litigation Release No. 18252, 2003 SEC LEXIS 1775 (July 28, 2003). The complaint alleged that J.P. Morgan Chase aided and abetted Enron's manipulation of its reported financial results through a series of complex structured finance transactions, called "prepays," over a period of several years preceding Enron's bankruptcy.

The SEC alleged that the prepay transactions were used by Enron to report loans from J.P. Morgan Chase as cash from operating activities.[1] The structural complexity of these transactions masked the fact that they were loans. The complaint alleged that J.P. Morgan Chase knew that the prepays allowed Enron to hide the true extent of its borrowings from investors and rating agencies because sums borrowed in prepay transactions appeared as "price risk management liabilities" rather than "debt" on Enron's balance sheet.

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1 In a typical "prepay" transaction, a purchaser pays for a commodity upfront and the seller agrees to deliver the commodity on future dates. Each side assumes commodity price risk. As alleged by the SEC, however, the J.P. Morgan Chase/Enron prepays employed a structure that passed the counter-party commodity price risk back to Enron. This was accomplished through a series of simultaneous trades whereby Enron passed the counter-party commodity price risk to a J.P. Morgan-sponsored special purpose vehicle, which passed the risk to J.P. Morgan, which, in turn, passed the risk back to Enron. As in typical prepays, Enron received cash upfront. However, with all elements of the structure taken together, Enron's future obligations were reduced to the repayment of cash it received from J.P. Morgan Chase with negotiated interest. In substance, therefore, these prepays were loans.

Without admitting or denying the allegations of the complaint, J.P. Morgan Chase agreed to settle the action by consenting to a final judgment permanently enjoining it from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. It also agreed to pay disgorgement, penalties, and interest totaling $135 million.

Another recent enforcement action against Merrill Lynch & Co., Inc. also illustrates the potential liability of a financial institution for aiding and abetting an issuer's violations of the federal securities laws. See Litigation Release No. 18038, 2003 SEC LEXIS 620 (March 17, 2003). In that case, the SEC alleged that Merrill Lynch and Enron entered into two 1999 year-end transactions that, while perhaps not technically structured finance transactions, had the purpose and effect of overstating Enron's reported earnings.

The first transaction was an asset-parking arrangement in which Merrill Lynch bought an interest in Nigerian barges from Enron with an express understanding that Enron would arrange for the sale of this interest by Merrill Lynch within six months at a specified rate of return. In substance, this transaction was a bridge loan because the risks and rewards of ownership of the interest in the barges did not pass to Merrill Lynch. As further alleged in the complaint, Merrill Lynch knew that Enron would record $28 million in revenue and $12 million in pre-tax income in connection with this transaction. In 2000, Enron arranged to take Merrill Lynch out of the barge deal within the agreed upon time frame and at the agreed upon rate of return.

In the second transaction, Merrill Lynch and Enron allegedly entered into two energy options that Merrill Lynch knew had the purpose and effect of inflating Enron's 1999 income by approximately $50 million. At year-end 1999, the trading under these options was not scheduled to begin for approximately nine months. Before the transaction was closed, Enron allegedly told Merrill Lynch that it might want to unwind the transaction before the end of the nominal term of four years. Merrill Lynch believed that the two trades were essentially a wash and knew that the transaction would have a significant impact on Enron's reported results, bonuses, and stock price.

The SEC charged Merrill Lynch with aiding and abetting violations of Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5), and Exchange Act Rules 10b-5, 12b-20, 13a-1, 13a-13, and 13b2-1. Without admitting or denying the allegations of the complaint, Merrill Lynch agreed to settle the charges by consenting to an injunction and payment of $80 million in disgorgement, prejudgment interest, and civil penalties.

c. Liability for Causing Violations

Rule 13b2-1 prohibits any person from directly or indirectly, falsifying or *causing* to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act. Accordingly, a financial institution can be charged with causing an issuer's falsification of its books and records. The SEC could pursue this charge in a U.S. district court civil action or in an administrative action.

In addition, Section 21C of the Exchange Act authorizes the SEC to enter an administrative cease-and-desist order against any person who has been "a cause of" a violation of any provision of the Exchange Act through an act or omission that the person knew or should have known would contribute to the violation. Section 21C liability has a broad reach. As with aiding and abetting liability, a financial institution could be liable for "causing" the violation of another, including an issuer's reporting, recordkeeping, or internal controls violations. Moreover, at least where the primary violation is non-scienter based, an actor may cause the violation through negligent conduct that contributes to the violation, without a showing of intent or recklessness. See KPMG, LLP v. SEC, 289 F.3d 109 (D.C. Cir. 2002).

The SEC's recent administrative action against Citigroup, Inc. illustrates the type of conduct that can result in Section 21C liability for a financial institution that participates in deceptive structured finance transactions. See Exchange Act Release No. 48230, 2003 SEC LEXIS 1778 (July 28, 2003). In that action, the SEC found that Citigroup was a cause of Enron's and Dynegy, Inc.'s violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

The SEC alleged that Citigroup engaged in prepay transactions with Enron that, while structured somewhat differently from the J.P. Morgan transactions, had the same overall purpose and effect. The SEC also alleged that Citigroup participated in two other transactions with Enron that were designed to transform cash from financing into cash from operations. In one, Citigroup knowingly helped Enron structure a transaction that allowed Enron to generate cash from operating activities by selling Treasury bills bought with the proceeds of a loan. The other transaction was structured by Enron as a sale of an interest in its pulp and paper businesses to a special purpose entity capitalized by Citigroup with a $194 million loan and $6 million in equity. In substance, however, this transaction amounted to a $200 million loan from Citigroup, because Citigroup was not at risk for its equity investment in the project.

Citigroup also allegedly participated in a complex financing in which Dynegy characterized what was effectively a $300 million loan as cash from operations, to conceal a mismatch between its earnings and cash flow from operations. This structure served to suppress questions about the quality of Dynegy's earnings and its ability to sustain those earnings.

In settling this action, Citigroup consented to issuance of an order to cease and desist from committing or causing future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. It also agreed to pay $120 million in disgorgement, penalties, and interest.

C. CONCLUSION

Depending upon the facts and circumstances, a financial institution could be liable for securities law violations when it offers deceptive structured finance products to, or participates in deceptive structured finance transactions with, a U.S. publicly traded company. A financial institution could have primary liability for antifraud violations. More commonly, it could be liable for aiding and abetting antifraud, reporting, recordkeeping, and internal controls violations. It also could be liable for causing such violations.