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July 19, 2004

via email

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Communications Division  
Mailstop 1-5  
Office of the Comptroller of the  
Currency  
250 E Street, SW  
Washington, DC 20219  
Re: Docket No. 04-12  
[regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov)

Chief Counsel's Office  
Office of Thrift Supervision  
1700 G Street, NW  
Washington, DC 20552  
Re: Docket No. 2004-27  
[regs.comments@ots.treas.gov](mailto:regs.comments@ots.treas.gov)

Ms. Jennifer J. Johnson, Secretary,  
Board of Governors of the  
Federal Reserve System  
20th Street & Constitution Avenue, NW  
Washington, DC 20551  
Re: Docket No. OP-1189  
[regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)

Mr. Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW.  
Washington, DC 20549-0609  
Re: Release No. 34-4969  
[rulecomments@sec.gov](mailto:rulecomments@sec.gov)

Robert E. Feldman, Executive Secretary  
Attention: Comments/OES  
Federal Deposit Insurance Corporation  
550 17th Street, NW  
Washington, DC 20429  
[comments@fdic.gov](mailto:comments@fdic.gov)  
Regulation Comments

Re: Proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities; **OCC** Docket No. 04-12; **OTS** No. 2004-27; **FRB** Docket No. OP-1189; **FDIC** (no docket number given); **SEC** Release No. 34-4969; 69 Federal Register 28980; May 19, 2004

Ladies and Gentlemen:

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency; the Office of Thrift Supervision, and the Securities and Exchange Commission have requested comments on a proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities (Statement). The Agencies state in the preamble to the Statement that it was developed largely in response to investigations into certain transactions conducted by Enron Corporation. The Statement describes a number of internal controls and risk management procedures that the Agencies believe are particularly useful in assisting financial institutions to ensure that their complex structured financial activities are conducted in accordance with applicable

law and that institutions effectively manage the full range of risks associated with these activities, including legal and reputational risks. The Statement would be of importance to any commercial bank or savings association participating in any way in a complex structured finance transaction. The American Bankers Association (ABA) brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership - which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks - makes ABA the largest banking trade association in the country.

## **General Comments**

The American Bankers Association appreciates that the Agencies granted a 30-day extension in the comment period. We joined in that request for additional time after a surprising number of financial institutions expressed to us serious concerns about the proposed Statement. It is clear from the proposal that the Agencies are seeking to provide helpful assistance and guidance to bankers in order to avoid legal, reputational and regulatory problems with complex structured finance activities.

We begin by noting that the American Bankers Association and bankers support the Agencies' efforts to provide guidance to financial institutions about the risks and the necessary internal controls that financial institutions need in order to avoid the legal, regulatory and reputational risks associated with complex structured finance activities. We concur with the Agencies that complex structured finance activities require rigorous and disciplined analysis, internal controls, risk management and corporate governance, executed by professionals in multiple disciplines and involving senior management throughout the process. Implementation of such best practices and fostering an unambiguous culture of professionalism, responsibility and integrity are essential. We understand that the Agencies intend the Statement to be of assistance to financial institutions, and we support that goal. However, ABA believes that the proposed Statement needs material revision before it can achieve that purpose.

In the final analysis, bankers are concerned that the Statement actually imposes additional risk on financial institutions, if it is adopted as proposed. They suggest that the Statement creates obligations and responsibilities that do not currently exist in law, regulation or practice. In many ways, the Statement appears to be making new law. We believe that the imposition, or even suggestion, of new obligations and responsibilities beyond the requirements of existing law, regulation or best practice gives rise to two related but distinct areas of concern – both of which increase rather than diminish the risk to financial institution participants in complex structured finance.

First, inevitably the Guidance will be viewed as a standard of care – both substantively and procedurally – one which is different than that which has evolved through decades of legislation, jurisprudence and best practice. From the perspective of plaintiffs, prosecutors, examiners and courts, financial institution providers of complex structured finance will assume a measure of responsibility, and hence liability, which has heretofore been the province of a customer's board and management – as well as its professional advisors. Second, by requiring significantly greater inquiry and involvement in the deliberations and processes of the customer, the financial institution's degree of involvement will bring it within the ambit of at least some of the existing tests for liability under the securities, accounting and fiduciary laws. The result will be that litigants will use the Statement as a new, additional basis for claims against financial institutions, increasing rather than decreasing legal and reputational risk to financial institutions.

Our members also are concerned that the Statement is unclear in important particulars: it appears to be overly broad in its application, potentially covering many transactions that the Agencies do not intend to cover. It also appears to not distinguish among the distinct roles financial institutions play in these transactions, roles that have differing responsibilities as well as risks. It also appears to fail to adjust its requirements for varying degrees of participation and risk with complex structured finance transactions.

## **Specific Comments**

The Statement suggests obligations that do not currently exist in law, regulation or practice ABA believes that the primary cause of all of these concerns is the Statement's insistent subtext that financial institutions must, shall, and/or should insert themselves into their customers' business dealings and corporate governance in ways not necessary or even supported by current law. We believe that the Statement should more appropriately provide guidance on necessary internal controls rather than expect banks to engage in policing the knowledge and intentions of a customer. By doing so, banks risk exposing themselves to much legal uncertainty and the possibility of increased, rather than reduced, reputational and litigation risk. In particular, when coupled with the detailed obligations on banks to seek assurances from customers, their auditors and third party advisors, the approach risks inflicting upon institutions and their executives the danger of being characterized as actively engaging in the management of the customer and thus becoming legally liable for the actions of the customer.

We believe that this result arises from the Statement's apparent assumption that the securities law relating to the issues presented in the Enron collapse is settled and clear. We believe that is not the case. To use just one issue as an example, we refer you to the law on the liability in securities sales of secondary actors for misrepresentations.<sup>1</sup> In the latest issue of The Business Lawyer, author A. J. Frumento argues that the SEC has sought to impose liability in such cases of major participation by the secondary actor, as an aider or abettor. However, the Circuits are divided between the "bright line" test of the Second, Tenth and Eleventh Circuits and the looser "significant participation" test of the Ninth Circuit. "Under the bright line test, only a person who both makes a misrepresentation and is publicly identified as the author can be liable under Rule 10b-5(b). Under the Ninth Circuit rule, persons who 'substantially participate' or play a 'significant role' in making a misrepresentation, even if not publicly identified as authors, can also be liable."<sup>2</sup>

The legal situation has now been confused further with the decision in In re Enron, in which Judge Harmon adopted a "creation" test, which appears to owe much of its own creation to an *amicus* brief filed by the SEC. Frumento argues that this approach is in contradiction of the U. S. Supreme Court's ruling in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,<sup>3</sup> in which the Supreme Court repudiated the SEC's assertion that the terms "directly or indirectly" in Section 10b established liability for aiders and abettors: "the text of the 1934 Act does not itself reach those

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<sup>1</sup> Frumento, Aegis J., "Misrepresentations of Secondary Actors in the Sale of Securities: Does *In re Enron* Square with *Central Bank*?", 59 Business Lawyer 975 *et seq.* (May, 2004).

<sup>2</sup> *Id.* at 976.

<sup>3</sup> Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 188-91 (1994).

who aid and abet a Section 10(b) violation.” Our point here is not that we know what the law is, rather our point is that the law on secondary actor liability is still unsettled. With that in mind, we now need to review the implied statement of the law on secondary actors found in the Agencies’ (including the SEC) Statement.

The Statement imposes (on a financial institution, since the Statement is Guidance for financial institutions under the jurisdiction of the four banking agencies) extensive obligations and responsibilities in connection with a customer’s or counterparty’s tax, regulatory and accounting treatment of a specific transaction without regard to the financial institution’s role in the transaction or conduct in connection with it.<sup>4</sup> The Statement provides that financial institutions should:

- obtain and document complete and accurate information regarding a customer’s proposed accounting treatment and financial disclosure relating to a transaction, as well as the customer’s objectives;
- assess the customer’s business objectives for entering into a transaction;
- evaluate the appropriateness of the transaction;
- obtain acknowledgment from a customer that a transaction has been reviewed and approved by higher levels of the customer’s management if circumstances warrant;
- conduct a comprehensive review of the financial institution’s entire relationship with a customer when necessary;
- ensure that the customer understands the risk and return profile of a transaction; and
- analyze and document customer-related accounting, regulatory or tax issues.

What concerns us is that this appears to be a roadmap for a financial institution to “substantially participate” in the structured finance transaction, as that analysis would be used under the Enron creation test to establish liability, in the event the transaction was fraudulent or even if it was not, but it was used for a fraudulent purpose by the customer. Under current law, financial institutions are not (and we believe should not) be responsible for the disclosure, tax and accounting obligations or risk assessments of their customers and counterparties, unless the financial institution is directly participating in the transaction. Nor are they responsible for appraising the suitability of a particular transaction for a customer or counterparty. These are the responsibility of the customer’s management, board of directors, accountants and lawyers. However, by requiring a level of participation beyond industry practice, the Agencies appear to be establishing as settled law the “creation test” decision in Enron. We believe this is a premature and inappropriate making of law by the Agencies.

Many bankers read the Statement as extending the obligations of financial institutions considerably beyond the existing obligations. The Statement seems to impose in all cases a duty to police customer accounting, disclosure and tax practices, and to assure the suitability of a transaction for a customer, when the institution participates in or facilitates a complex structured financial

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<sup>4</sup> Financial institutions may take on significant additional responsibilities in certain circumstances, such as when a customer formally and intentionally retains and compensates a financial institution for undertaking an advisory or other fiduciary role with respect to the customer. In those alternate roles, the financial institution assumes addition liability. However, even then, final determination of tax, accounting and disclosure issues may fall beyond the specific scope or time span of the financial institution’s engagement.

transaction.<sup>5</sup> We agree, and we view the Statement as writing new law, with attendant, serious additional consequences:

- greatly increased potential liability and exposure to loss;
- new costs and burdens as financial institutions take steps to minimize their liability and exposure;
- diminished responsibility and accountability on the part of the customer; and
- reduction in the economic viability of some structured finance transactions.

### The Statement is Overly Broad in Scope and Requirements

#### a. The definitions of covered transactions appear overly broad

The key terms specifying the scope of the Statement, “complex structured finance activities,” “complex structured finance transactions” and “heightened risk,” are defined by the Statement by a series of “non exclusive” general and ambiguous criteria. The Statement mentions financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, and specialized financial conduits that manage pools of purchased assets, specifically, but the Statement’s broad listing of criteria has raised concerns with some bankers that even common financial transactions could be pulled into examiners’ scrutiny. The Statement provides that financial institutions will need to supplement and modify these criteria to identify transactions that fall within their scope. Some bankers have even expressed concern that larger loan participations might fall within the scope of the Statement.

If the Statement were just an explication of the risk considerations and the applicable law, then such general criteria are manageable – the financial institution would use the criteria in the institution’s internal analysis of how to structure its risk management. If the Statement were clear that the determination of which transactions or categories of transactions increase risk and, therefore, require special attention, is entirely within the province of the financial institution in the exercise of its business judgment, reviewable only under the fabric of existing law, such an approach seems to be workable. However, when the Statement seems to adduce new law and impose significant new obligations, bankers find the potential scope of these definitions intimidating.

#### b. The Statement should distinguish the roles in which a financial institution assumes special obligations or responsibilities with respect to its customer.

A financial institution may play a number of different roles with respect to a particular complex structured finance transaction, including:

- a formal advisory role;
- an ongoing and integral role in the finances or other aspects of the customer or its business;
- a role in which the financial institution has structured or marketed the transaction as providing a particular accounting or tax result;
- an arm's-length provider of credit;

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<sup>5</sup> The Statement appears to us to exceed the obligations set out in recent settlements that the Agencies state form some of the basis of the Statement – the recent Citigroup, JP Morgan and Merrill Lynch orders.

- a fiduciary, agency or other arm's-length service provider role;
- a participant but not lead institution in a financing transaction; or
- a purchaser or seller of securities or other assets in the secondary market.

Each of these roles creates a different network of substantive and procedural responsibilities for that particular role. Under existing law, the obligations associated with the respective roles are distinct. For example, the obligations of an institution which has undertaken an advisory role are surely different from one that is an arm's-length provider of financing. And, an institution that markets the desirable regulatory, tax or accounting results expected from a complex financial product may assume different responsibilities, especially in the case of a relatively unsophisticated counterparty.

However, we believe that the Statement fails to properly distinguish among the multiple roles a financial institution may play in a complex financial transaction. We believe that the Agencies could significantly improve the proposal appropriately reflecting such distinctions in any final Statement. For example, when a financial institution structures and touts a transaction or strategy for a particular tax, accounting or disclosure effect, the institution may also assume an elevated level of responsibility. Existing law and regulatory regimes, ranging from the Investment Advisors Act of 1940 to governance of broker-dealers, as well as multiple theories of common law, address these duties and responsibilities. Without adding to existing law or the regulatory framework, it is clearly impermissible now to knowingly participate in a transaction or strategy the purpose of which is to deceive investors, regulators or tax authorities. Equally clearly, a financial institution could not prudently proceed with a transaction if it becomes aware of evidence indicating such intention, unless the institution, through additional review and careful consideration, determines that the transaction does not entail inappropriate risk or violate applicable laws or regulations. At a minimum, the Agencies should reduce the scope of the Statement to those roles in which a financial institution can reasonably be expected to assume some responsibility for a customer's tax, accounting or disclosure matters under current law.

c. The Statement imposes new documentation standards in excess of current law.

The new documentation standards in the Statement suggest affirmative substantive duties that are inappropriate and beyond the dictates of existing law, regulation or best practice. We find them overly broad and believe that they would impose significant costs and potential risk on financial institutions for activities that do not involve heightened legal or reputational risk. In particular, the documentation requirements for transactions that did not go forward appear excessive. The Statement would require documentation of transactions that are not approved, if such transactions involve controversial elements. This obligation is burdensome and unnecessary and appears to be designed to aid some of the Agencies in enforcement actions against other parties rather than the financial institution. A transaction may fail to close for any number of reasons, most of which are not problematic and do not relate to deceptive practices. Retaining extensive documentation regarding such transactions would require a significant commitment of staff time and storage expense, but would not yield any meaningful benefit in terms of managing legal or reputational risk. If a transaction is abandoned in its early stages, the proposed documentation requirement would impose an obligation on a financial institution to create a paper trail that is unnecessary for business purposes. Even if the failed transaction would have involved controversial elements had it been completed, such a requirement could needlessly and inappropriately involve the financial institution in third-party litigation and create potential exposure to the customer.

The Statement also proposes that financial institutions document and retain any formal or informal analysis or opinions, whether prepared internally or by others, that relate to legal considerations, tax and accounting matters, market viability and regulatory capital requirements. This obligation, particularly the requirement to retain records of informal communications, does not exist in current law and could have an unintended chilling effect on open discussions between financial institutions and their customers or counterparties. If any final Statement does require retention of analysis or opinions, only significant and formal materials should be covered.

Similarly, the proposal in the Statement that financial institutions maintain “minutes of critical meetings with clients” will hamper or prevent legitimate business negotiations and other discussions and could impede the completion of routine transactions. Creating such minutes would be impractical or impossible in the context of a fast-paced and complex transaction involving multiple parties and advisers, and customers would oppose such intrusive documentation of meetings in many, if not most, circumstances.

## **Conclusion and Recommendations**

Given the revelations of corporate misbehavior in the last few years, ABA concurs with the Agencies that complex structured finance activities require rigorous and disciplined analysis, internal controls, risk management and corporate governance, executed by professionals in multiple disciplines and involving senior management throughout the process. And a primary line of defense against wrongdoing is an unambiguous culture of professionalism, responsibility and integrity. Any additional guidance from the Agencies that assists financial institutions in complying with the law and managing the reputational, legal and regulatory risks of banking is appreciated. However, ABA believes that the proposed Statement needs considerable revision before it becomes this additional valuable guidance.

Our greatest concern is that the Statement appears to impose new obligations beyond current law that thrust financial institutions into participation with the customer in the transaction. Instead of this, the final Statement must present a comprehensive picture of the complex body of law, regulation and practice that has evolved with respect to the myriad of transactions and business activities apparently covered by the Statement. As the Statement is currently structured, we believe that by forcing financial institutions to intrude themselves into their customers’ businesses, the Statement actually increases the potential for liability for financial institutions offering complex structured finance transactions, a very counterproductive result. We note that we are not alone in this concern, as the British Bankers Association in their comments on the Statement express similar concerns about differences between existing law applicable to their members and the assumptions of the Statement. As the BBA wrote in its letter of June 18, 2004, “[The Statement] is insufficiently sensitive to the fact that banks coming to the US from elsewhere will have to implement the guidelines in banking structures and a legal framework which may be considerably different from typical US banking structures and legal frameworks. Our members foresee significant difficulty with regard to this legal consistency issue if the statement was to be applied to banks in different European jurisdictions. It may also bring them into procedural conflict with their home regulators. This issue is only one of several which arise from the implication that this policy initiative can and will be applied with ease on an extra-territorial basis.”

**We strongly recommend that the Agencies rewrite that Statement more in the form of an analysis of the existing law and potential risks, perhaps in a case study approach of specific examples, rather than as a guidance of mandated actions.**

**We recommend that the Agencies make clear that they do not intend the Statement to create new law or regulation or to impose standards of care and practice beyond the standards of current law.**

**We recommend that the Agencies rewrite the Statement so as to reflect the multiple roles of financial institutions in complex structured finance transactions and their differing obligations with respect to customer and counterparty disclosure under those different roles.**

**We urge the Agencies to discuss the significant body of law (i.e., the Sarbanes-Oxley Act) and regulation (including the stock exchange rules) on corporate governance that has sprung into existence since the collapse of Enron. Integrating these laws, regulations and best practices into the discussion could be of considerable assistance to smaller institutions.**

We note that the Statement gives little recognition to the differences in the obligations and responsibilities with respect to transactions involving individuals and private companies from those associated with public companies and from transactions with the public at large. **We recommend that the Statement at least acknowledge these differences.**

**We support the recommendation of the BBA that the Agencies “discuss the guidelines with European authorities such as the EU Commission and the Committee of European Banking Supervisors before finalizing them - with a view to seeking to avoid potential divergences of regulatory approach between the US and the EU. In this regard we note the recent CESR/SEC initiative to try and work together to produce common regulatory solutions which can operate in both a US and a European environment.”**

If any finally adopted Statement adds any of the additional documentation requirements or enlarges the responsibilities of financial institutions beyond existing law, as we have shown that the present Statement does, **then we recommend that any such Statement should expressly provide for an implementation period of at least six to nine months to allow financial institutions time to modify internal policies and procedures in order to comply.**

**Finally, we recommend that any revised Statement must be published with a request for comments, as the complexities of the Statement clearly require such additional review.**

If the staff of the Agencies have any questions about these comments, please call the undersigned.

Sincerely,



Paul Smith  
Senior Counsel