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Federal Agencies Issue Final Statement Concerning Elevated Risk Complex Structured Finance Transactions

On January 5, 2007, the Office of the Comptroller of the Currency, Treasury (“OCC”), the Office of Thrift Supervision, Treasury (“OTS”), the Board of Governors of the Federal Reserve System (“Board”), the Federal Deposit Insurance Corporation (“FDIC”), and the Securities and Exchange Commission (“SEC”) (collectively, the “Agencies”) issued a final statement (the “Final Statement”)¹ on sound practices concerning elevated risk complex structured finance transactions (“CSFTs”). The Final Statement applies to national banks, state banks, bank holding companies (other than foreign banks), federal and state savings associations, savings and loan holding companies, U.S. branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers (collectively, “financial institutions” or “institutions”) engaged in CSFTs.

The Final Statement will take effect as soon as it is published in the Federal Register.

I. Background

During the past decade, certain financial institutions appear to have been engaged in CSFTs used in illegal schemes that misrepresented the financial condition of public companies to investors and regulatory authorities. Such misrepresentations resulted in violations of the securities laws, particularly: (i) antifraud violations of Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Section 17(a) of the Securities Act of 1933; (ii) reporting violations of Section 13(a) of the Exchange Act (periodic reporting) as well as rules

¹ Release No. 34-55043; File No. S7-08-06 (January 5, 2007) available at <http://www.sec.gov/rules/policy/2007/34-55043.pdf>

13a-1, 13a-11, 13a-13, and 12b-20 under the Exchange Act; and (iii) recordkeeping and internal controls violations of Sections 13(b)(2)(A) and (B) of the Exchange Act. In May 2004, and after the OCC, the Board and the SEC conducted investigations and took actions involving the assessment of financial penalties on certain institutions, the Agencies issued and requested the institutions to issue comments on a proposed interagency statement, which after being revised constituted the basis for the Final Statement.

II. The Final Statement

In general, the Final Statement focuses on CSFTs that may pose elevated levels of legal or reputational risks for a participating financial institution and outlines key risk management policies, procedures and systems that may help a financial institution identify such transactions and appropriately manage the risk of engaging in them.²

The Final Statement has been adopted as supervisory guidance by the Board, OCC, FDIC and OTS and as policy statement by the SEC, which means that, it does not, by itself, establish any legally enforceable requirements or obligations. Notwithstanding the foregoing, the Agencies will use the Final Statement in reviewing the internal controls and risk management policies, procedures and systems of financial institutions engaged in CSFTs as part of the Agencies' ongoing supervisory process.

III. Elevated Risk CFTSs and Risk Management Principles

Financial institutions should establish and maintain policies, procedures and systems to identify elevated risk CFTSs. The Final Statement sets forth some examples of transactions that an institution may determine warrant additional scrutiny. The list, which is illustrative in nature and does not purport to cover all situations, provides that certain CSFTs may expose an institution to heightened legal and reputational risks if the transactions (either individually or collectively) appear to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when executed at year-end or end of a customer reporting period;

²

Most structured finance transactions, such as standard public mortgage-backed securities transactions, public securitizations of retail credit cards, asset-backed commercial paper conduit transactions, and hedging-type transactions involving "plain vanilla" derivatives and collateralized loan obligations, are familiar to participants in the financial markets, and these vehicles have a well-established track record. These transactions typically would not be considered CSFTs for the purpose of the Final Statement.

- Raise concerns the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;
- Involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) lacking economic substance or business purpose;
- Involve oral or undocumented agreements that would have a material impact on the regulatory, tax, or accounting treatment of the related transaction or the client's disclosure obligations;
- Have material economic terms inconsistent with market norms (e.g., deep "in the money" options or historic rate rollovers); or
- Provide the financial institution with compensation appearing substantially disproportionate to services provided, investments made, or credit, market or operational risk assumed by the institution.

The Final Statement also describes a series of policies and procedures that can be implemented by financial institutions which have identified elevated risks CSFTs. Suggested policies and procedures include:

- Due diligence commensurate with the level of risks identified, including independent assessment of the potential risks posed by a CSFT from the standpoint of the transaction and the institution's overall relationship with the customer.
- Review and approval by the appropriate levels of control and management personnel through a process that should include representative(s) from the relevant business line(s) and/or client management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. In order to monitor elevated risk CSFTs, some institutions have established senior management committees which include senior representatives from relevant control functions within the institution such as independent risk management, tax, accounting, policy, legal, compliance and financial control. If a financial institution determines that its participation in the CSFT being evaluated creates significant legal or reputational risks, the institutions should take actions such as declining to participate in the transaction or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction.
- Production and retention of sufficient documentation to allow the institution to: (i) document the material terms of the transaction; (ii) enforce the material obligations of the counterparties; (iii) confirm that customers have received required

disclosures concerning the transaction; and (iv) verify that policies and procedures are being followed and allow the internal audit function to monitor compliance with policies and procedures.

- Establishment of a “tone at the top” by the board and senior management through actions and formalized policies that send a strong message throughout the financial institution about the importance of legal compliance and good business ethics.
- Implementation of policies that provide for the appropriate levels of management and the board of directors of the institution to receive sufficient information and reports concerning CSFTs to enable them to perform their oversight function.
- Creation of a program establishing periodic independent reviews of the institution’s CSFT activities to verify and monitor that policies and controls are being implemented effectively.
- Development of regular internal audits to monitor adherence to the institution’s own controls, policies and procedures with regard to elevated risk CSFTs, including transaction testing.
- Creation of specialized and appropriate training programs for relevant personnel on policies and procedures for handling elevated risk CSFTs.

The Agencies have stated that the internal controls and procedures set forth in the Final Statement are only guidelines, and financial institutions may find that other policies are appropriate in light of their particular CSFTs activities. However, taking into consideration the potential risks associated with CSFTs, financial institutions should have effective risk management and internal control systems that allow them to identify, assess, manage and address the risks of such activities while at the same time conduct CSFTs in compliance with applicable laws.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; or Maria Brito at (212) 701-3668 or mbrito@cahill.com.