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

June 15, 2006

To the Agencies and Persons Named in Appendix A

Re: Revised Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities

The Bond Market Association,[1] the International Swaps and Derivatives Association, Inc.[2] and the Securities Industry Association[3] (collectively, the "Associations") welcome this opportunity to comment on the revised Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 71 Fed. Reg. 28,326 (May 16, 2006) (the "Revised Guidance").[4] The Associations appreciate and commend the significant steps taken by the Agencies to improve upon the original Proposed Interagency Statement on Sound Practices Regarding Complex Structured Finance Activities, 69 Fed. Reg. 28,980 (May 19, 2004) (the "Original Proposed Guidance") in response to public comment. We believe the Revised Guidance provides a clear and flexible set of principles that will enable financial institutions to design internal controls for the review and approval of complex structured finance

[1] The Bond Market Association represents approximately 200 firms that underwrite, trade or invest in fixed income securities, both in the U.S. 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"), which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has approximately 700 member institutions from 50 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

[3] The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. More information about SIA is available at: www.sia.com.

[4] 71 Fed. Reg. 28,326 (May 16, 2006); Office of the Comptroller of the Currency Docket No. 06-06; Federal Reserve System Docket No. OP-1254; Office of Thrift Supervision No. 2006-20; Securities and Exchange Commission Release No. 34-53773; File No. S7-08-06. 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 that may pose heightened levels of legal or reputational risk ("elevated risk CSFTs") in a manner consistent with sound risk management principles and each institution's individual circumstances.

The Associations' relatively few remaining comments are discussed in Section I below and consist primarily of clarifications. In the case of the Agencies' proposed documentation recommendations, however, the Associations respectfully request that the Agencies reconsider any requirement that financial institutions document the "reasons" for their approval, conditional approval or disapproval of an elevated risk CSFT. Section II of this letter addresses certain issues raised in comments previously submitted to the Agencies.[5]

I. DISCUSSION OF THE REVISED GUIDANCE

Documentation Standards

The Revised Guidance provides that:

> When an institution's policies and procedures require an elevated risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation that reflect management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the reasons for such action.[6]

The Associations do not agree that a financial institution should be required to create a memorialization — that it would not otherwise create — of the reasons for its approval, conditional approval or disapproval of an elevated risk CSFT.[7] The determination whether to document the reasoning behind approval (or disapproval) of an elevated risk CSFT should be left to the judgment of senior management based on the relevant circumstances and the nature of the issues considered. While the obligation to record the "reasons" for approval, conditional approval or disapproval may appear innocuous, the Associations believe that any such obligation would create potentially significant risks and burdens for financial institutions that would not be justified by any discernible benefits.[8]

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[5] See Comment Letter from George M. Cohen, Susan P. Koniak, David A. Dana & Thomas Ross to the Agencies (June 2, 2006).

[6] 71 Fed. Reg. at 28,334.

[7] We have assumed that the Revised Guidance contemplates a substantive discussion of the reasoning for an institution's approval (or disapproval) of, or imposition of conditions with respect to, an elevated risk CSFT, and not merely a recordation that the transaction was approved based on the conclusion that it presented an acceptable level of risk.

[8] The Associations question the regulatory basis for requiring a financial institution to justify a determination to reject a CSFT. A determination to reject a transaction, by its nature, does not require the level of confidence in a legal, tax or accounting conclusion that would be appropriate in the context of a transaction that is executed. Indeed,

The Associations agree that it is important for financial institutions to establish effective documentation policies and procedures consistent with applicable legal and business requirements. Accordingly, the Associations recognize that the minutes (or other record) of any meeting[9] of senior personnel that is convened to review an elevated risk CSFT should be adequate to identify the transaction under consideration and record the action — whether approval, conditional approval or disapproval of the transaction — taken at the meeting. The text cited above, however, goes well beyond a recordkeeping requirement of this kind.

Elevated risk CSFTs frequently present a number of potentially complex legal, tax or accounting issues. If financial institutions are required to prepare a written memorialization of their analyses of such issues, and will be examined, with the benefit of hindsight, with regard to the scope and quality of those written analyses, they will legitimately feel compelled to go to significant lengths to evidence the scope and quality of their consideration of all the potential risks associated with an elevated risk CSFT. Put differently, financial institutions — *purely to protect themselves from being criticized for failure to comply with the proposed documentation requirement* — will generate a demand for documentation of their legal, tax or accounting analyses and conclusions that bears little or no relation to what management believes, in the exercise of good judgment, is appropriate under the circumstances presented by an individual transaction. The Associations believe that the attendant expense and burden on resources is not justified, would increase the costs of elevated risk CSFTs and, in extreme cases, could have a chilling effect by tipping the balance of costs and potential revenues.[10]

Regulated entities make judgments every day in every aspect of their businesses that require the exercise of accounting, tax or legal judgments. We cannot identify another context in which there is a requirement that an entity contemporaneously document the analytical (as opposed to factual) basis for each such conclusion. Of course, in evaluating any complex legal, tax or accounting issue(s) in connection with an elevated risk CSFT, a financial institution should consider whether a written analysis of the relevant issue(s) would be desirable or

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rejection does not even require, as a business matter, that an institution reach any definitive conclusion.

The Agencies clearly do not intend to use the documented reasons for rejecting a transaction as a basis to criticize a financial institution for declining to engage in a CSFT. Documentation of a rejected transaction, by definition, has no probative value in determining whether an institution inappropriately approved an elevated risk CSFT or failed to comply with its own policies or procedures in connection with an elevated risk CSFT. The Associations believe that financial institutions should not be saddled with the obligation and expense of creating documents they may not otherwise create and that are not necessary for purposes of evaluating their compliance with applicable regulatory guidance or internal policies and procedures.

[9] We note that consideration of an elevated risk CSFT by senior management could occur without convening a formal meeting at which all participants are simultaneously present.

[10] It bears noting that the creation and production of a document that includes the legal analysis underlying approval or disapproval of a transaction could compromise the attorney-client privilege that would otherwise be applicable to the subject matter of such a document. We do not believe that it would be appropriate to require financial institutions to jeopardize the privilege that would otherwise attach to their analyses absent a compelling reason to do so.

appropriate.[11] Nonetheless, the determination whether to create or obtain a written analysis of the basis for a particular legal, accounting or tax conclusion is in all other contexts, and should in this context be, left to the judgment and discretion of the managers of the process.

For the foregoing reasons, the Associations respectfully request that the Agencies reconsider and eliminate the imposition of any requirement that a financial institution document the reasons for its approval (or disapproval) of, or imposition of conditions with respect to, an elevated risk CSFT.

Reporting to Senior Management and Periodic Independent Review

The Revised Guidance states that a financial institution's policies and procedures should provide appropriate levels of management and the board of directors with information and reports concerning the institution's elevated risk CSFTs that are sufficient for them to perform their oversight functions.[12] Clearly, management and the board of directors must have appropriate information to perform their oversight functions. The Associations do not believe, however, that senior management (other than those directly involved in the review of individual elevated risk CSFTs), or the board of directors, should review transaction-level data regarding elevated risk CSFTs. Instead, the focus of any such review should be on general oversight of the efficacy of the institution's risk control systems and risk trends.

Accordingly, the Associations respectfully request clarification that the reports to be provided to senior management and the board of directors for these purposes should relate to the efficacy of the approval process, trends and aggregate levels of risk, rather than to individual transactions or transaction-specific issues.

The Revised Guidance also provides that financial institutions should conduct *periodic independent reviews* of their CSFT activities to verify that their policies and controls relating to elevated risk CSFTs are being implemented effectively and that elevated risk CSFTs *are accurately identified* and *receive proper approvals*.[13] The Associations would appreciate further clarification regarding the text highlighted above. Internal audit should evaluate compliance with policies and procedures and the efficacy of such policies and procedures in capturing transactions for review. However, it is not realistic to expect internal audit, other control units, senior management or third parties to duplicate and independently assess the quality of the substantive judgments that are made in connection with the approval of individual CSFTs.

The Associations believe that the objectives articulated in the Revised Guidance can be effectively satisfied by establishing an appropriate framework for verifying that: internal

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[11] If a financial institution's legal analysis of a risk factor is wrong, it may well be accountable regardless of the quality of its contemporaneous analysis. In certain cases, the existence of a documented legal analysis that provides a reasonable basis for reliance on a conclusion of law will provide legal risk mitigation.

[12] 71 Fed. Reg. at 28,334.

[13] Id. (emphasis added).

policies and procedures are complied with; transactions do not escape review; and any heightened review is conducted by a combination of knowledgeable and independent control personnel and management. Responsibility for periodic review of the overall efficacy of a financial institution's framework for review and approval of elevated risk CSFTs does rest with the institution's board of directors, its audit committee or another designated senior management group. While this review may identify trends or weaknesses in the control framework that merit remediation, the review should not be regarded as an independent effort to evaluate the specific judgments that are made in connection with the review of an individual elevated risk CSFT.

The Associations accordingly respectfully request clarification that the reference to "periodic independent review" in the text quoted above would be satisfied by a combination of compliance with the periodic internal audit recommendations and overall review of the elevated risk CSFT process by the board, audit committee or other designated senior management group as described above.

Employee Compensation and Incentive Structures

The Revised Guidance recommends that a financial institution structure its compensation and incentive plans with respect to elevated risk CSFTs so as to provide personnel with appropriate incentives to have due regard for the legal, ethical and reputational risk interests of the institution.[14] The Associations agree that compensation and incentive policies should be designed to promote the effective management of legal, ethical and reputational risks generally and in connection with elevated risk CSFTs.

The Associations note, however, that there is no effective way to provide direct and measurable compensation incentives for conduct consistent with these objectives. Nonetheless, the Associations recognize and agree that in determining employee compensation levels and incentives, an employee's performance, positive or negative, with respect to these risk management objectives should be an important consideration, as a matter of institutional policy. The Associations would welcome confirmation by the Agencies that such an approach would be consistent with the Revised Guidance.

Due Diligence

The Revised Guidance provides that a financial institution "should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risks to the institution or would result in a violation of applicable laws, regulations or accounting principles."[15] The Associations agree that a financial institution should examine an elevated risk CSFT and decide not to proceed with the transaction if the institution determines that the transaction would present unacceptable legal or reputational

[14] Id.

[15] Id. at 28,333.

risks. Of course, as a practical matter, the legal, tax or accounting issues presented by an elevated risk CSFT are not black and white.

CSFTs are, by their nature, innovative and, as a result, tend to raise new and complex issues never contemplated by the statutes, regulations and other guidelines to which they may be subject. If the mere existence of uncertainty from complex and novel issues were a basis to refrain from innovation, many important and beneficial risk management tools, such as swaps, that at an earlier time were subject to considerable uncertainty, would likely not be widely available today. In circumstances where issues are not entirely clear, management must exercise its best judgment in determining whether the issues raised by a particular transaction give rise to legal or reputational risks that are acceptable or unacceptable. The Associations assume that this is consistent with the intent of the Agencies.

U.S. Branches and Agencies of Foreign Banks

The Revised Guidance provides that a U.S. branch or an agency of a foreign bank should coordinate its policies and procedures for CSFTs with the institution's group-wide policies and implement a control infrastructure for CSFTs, including management, review and approval requirements.[16]

The Associations agree that U.S. branches and agencies of foreign banks should harmonize their policies and procedures with the institution's global policies. Many foreign banks maintain strong unified control systems that oversee the risk management of the institution on a global basis. The Associations believe, however, that the second sentence in footnote 7 of the Revised Guidance[17] may be construed as obligating U.S. branches and agencies of foreign banks to establish a control infrastructure that is additional to, rather than an integral part of, the foreign bank's global control framework. The Associations respectfully request that the Agencies clarify that the Revised Guidance is not intended to require U.S. branches and agencies of foreign banks to establish separate control infrastructures where adequate institutional controls are otherwise in place and apply to the branch or agency.[18]

Composition of Effective Senior Management Committee

The Revised Guidance states that effective evaluation of elevated risk CSFTs may be conducted by a senior management committee that includes experienced representatives from

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[16] Id. at 28,332 n.7.

[17] Id.

[18] We believe that this issue can be effectively addressed by modifying footnote 7 in the Revised Guidance to read:

> In the case of U.S. branches and agencies of foreign banks, the institution should coordinate these policies with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor and in a manner consistent with the institution's overall corporate and management structure as well as its framework for risk management and internal controls.

relevant control functions within the institution, including "such groups as independent risk management, accounting, policy, legal, compliance and financial control."[19] The Associations acknowledge that an effective review process depends heavily on the involvement of knowledgeable control personnel from multiple disciplines. However, many financial institutions do not have a separate "policy" group and it is unclear to the Associations precisely what the reference to a policy group is intended to encompass. Most financial institutions do, on the other hand, have internal tax groups that perform a control function. The Associations respectfully recommend that the Agencies include a reference to "tax" in the provision of the Revised Guidance referenced above and either delete the reference to "policy" or clarify the function that a "policy" group is intended to perform.

II. OTHER COMMENTS

The Associations believe that the comment letter cited above[20] mischaracterizes the Revised Guidance and fundamentally misapprehends its purpose.

Condoning Illegal Conduct

The authors of the comment letter argue that the Revised Guidance fails to require financial institutions to conduct heightened review of transactions that are, in the authors' view, inherently fraudulent. The authors regard this as tantamount to "permission" for financial institutions to aid and abet their clients' fraudulent transactions.[21] These characterizations simply do not withstand scrutiny.

According to the authors, the illustrative transactional characteristics listed in the Revised Guidance are "so strongly suggestive of fraud that it is near impossible to imagine how they signal anything else."[22] This statement reflects a lack of familiarity with CSFTs.[23] Each of the enumerated characteristics merely identifies circumstances that could be indicative of improper intent or purpose. Whether any one or more of the transactional characteristics is in fact indicative of fraud will depend entirely on the specific circumstances of the transaction.[24] In

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[19] 71 Fed. Reg. at 28,333 (emphasis added).

[20] Note 5. The authors of the comment letter recently acted on behalf of the plaintiffs in litigation relating to the Enron civil matter. They do not otherwise appear to have extensive expertise in supervisory policy or structured finance.

[21] Id. at 2.

[22] Id. at 6.

[23] Of course, if the transactional characteristics of elevated risk CSFTs enumerated in the Revised Guidance were, indeed, inherently fraudulent, the mandatory heightened review called for by the authors would be superfluous.

[24] For example, because CSFTs are, by their nature, highly customized transactions designed to accomplish the unique commercial objectives of a particular client, they may routinely involve non-standard documentation, without such customization being in any way indicative of impropriety. Similarly, transactions, such as deep-in-the-money options and historic rate rollovers, that have embedded financing or that could conceal losses are not inherently fraudulent. Such transactions can be effected for entirely legitimate purposes. They may be disclosed to

many cases, the determination will depend on the proposed disclosure (or absence of disclosure) relating to the transaction.

The comment letter goes on to criticize the Revised Guidance for providing that financial institutions *may* wish to review transactions with such characteristics.[25] The authors contend that this permissive standard in effect gives a free license to financial institutions to participate in, and turn a blind eye to, even inherently fraudulent transactions by their clients. This contention stems from a fundamental misreading of the Revised Guidance. The relevant section of the Revised Guidance states:

> Examples of transactions that an institution *may* determine warrant this additional scrutiny are … provided for *illustrative purposes only* … The goal of each institution's policies and procedures … *should* [be] to identify those CSFTs that warrant additional scrutiny in the transaction or new product approval process due to concerns regarding legal or reputational risk.[26]

The Revised Guidance is clear and unequivocal that financial institutions *should* subject transactions that present heightened legal or reputational risk to enhanced scrutiny.[27] Contrary to the authors' reading of the Revised Guidance, the word "may" in the text quoted above reflects the Agencies' recognition that the enumerated transactional characteristics — while they raise questions — may not be evidence of fraudulent intent or other abuse, depending on the relevant circumstances and may not, as a result, necessitate heightened review where those circumstances are understood. On the other hand, since these transactional characteristics are "provided for illustrative purposes only" other, entirely different characteristics of a proposed

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management and shareholders. They might mature prior to expiration of the relevant accounting period. In each of these and innumerable other variations, front office personnel of the financial institution could possess the information necessary to determine that the institution may legitimately participate in the transaction, entirely obviating the need for the heightened scrutiny that a more inflexible rule, such as that proposed by the authors, would mandate.

[25] Note 5 at 2.

[26] 71 Fed. Reg. at 28,332 (emphasis added).

[27] The Revised Guidance also states that:

> Because of the potential risk they present to the institution, transactions or new products identified as elevated risk CSFTs *should* be subject to heightened reviews during the institution's transaction or new product approval process. . . . Having developed a process to identify elevated risk CSFTs, a financial institution *should* implement policies and procedures to conduct a heightened level of due diligence for these transactions.

Id. at 28,332-33 (emphasis added).

transaction may warrant additional scrutiny because they raise concerns of increased legal or reputational risk.[28]

Nothing in the Revised Guidance incentivizes a financial institution to ignore warning signs of potential improprieties that could lead to liability, primary or secondary.

Discussion of *Central Bank*

Although perhaps invited by some of the commentary on the Original Proposed Guidance, the authors' discussion of the *Central Bank* decision[29] is, nonetheless, irrelevant to the Revised Guidance.[30]

The Revised Guidance is not intended to establish normative standards of liability, civil or criminal. That is Congress's role. The Revised Guidance constitutes supervisory guidance addressed to regulated entities by their regulators. Like other supervisory guidance, it is designed to articulate standards for financial institutions in designing and implementing effective internal controls and risk management procedures — in this case, to manage and address risks presented by elevated risk CSFTs. The Revised Guidance incorporates whatever standards exist under applicable law for establishing the liabilities of financial institutions. Nothing in the Revised Guidance insulates financial institutions from the need to effectively manage their activities in light of those standards.[31]

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[28] The Associations believe that, by citing non-exclusive examples of transactional characteristics that may warrant further scrutiny, the Agencies have struck a more appropriate balance in the Revised Guidance than in the Original Proposed Guidance, which proposed a fixed and over-inclusive list. By providing non-exclusive examples while affirming the responsibility of financial institutions to identify significant legal and reputational risks, the Revised Guidance properly maintains the flexibility necessary to regulate an ever-changing and innovative market that offers transactions that are highly customized to meet clients' diverse yet legitimate objectives.

[29] Central Bank of Denver v. First Interstate Bank, 511 U.S. 164 (1994).

[30] In fact, we concur that Central Bank does not affect standards of liability in criminal or civil administrative actions for aiding and abetting fraud.

[31] In fact, as the Agencies are aware from their examinations, financial institutions evaluate "reputational" in addition to "legal" risks, consistent with the admonitions of the Revised Guidance. As a result, financial institutions rely on a more "risk averse" standard for evaluation than prevailing standards for strict legal liability. The Revised Guidance, by providing standards for legal and reputational risk management in the context of elevated risk CSFTs, is consistent with this more expansive approach to risk avoidance.

The authors' fears of "reckless indifference" by financial institutions to their clients' fraudulent transactions are contradicted by the considerable steps financial institutions have taken, as the Agencies have noted in the Revised Guidance, to better control and manage the legal or reputational risks that may be presented by elevated risk CSFTs and other business activities. In particular, financial institutions have significantly increased the resources allocated to their legal, compliance and control functions.

Conclusion

The charges the authors have leveled at the Revised Guidance have more sensational value than substance. The Revised Guidance is a product of careful deliberation. It recognizes the complex and evolutionary character of CSFTs and effectively balances the need to employ resources wisely and to promote institutional focus on those situations that in fact warrant enhanced scrutiny. In contrast to the authors' preferred reliance on an over-inclusive list of presumptively prohibited characteristics, the Agencies' principles-based approach avoids the elevation of form over substance. The Associations believe that the Revised Guidance represents a significant step forward, consistent with the approach to these supervisory issues other sophisticated international supervisors, such as the Financial Services Authority in the United Kingdom, have adopted.[32]

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[32] See, e.g., Letter from Hector Sants, Financial Services Authority, to the Chief Executive Officers of FSA-Regulated Firms Regarding Conflicts of Interest and Non-Standard Transactions (Nov. 10, 2005).

The Associations appreciate the opportunity to comment on the Revised Guidance. Please do not hesitate to contact Marjorie E. Gross, Senior Vice President and Regulatory Counsel of The Bond Market Association (646 637-9204), Greg Zerzan, Counsel and Head of Global Public Policy of the International Swaps and Derivatives Association, Inc. (202 756-2980), Ira Hammerman, Senior Vice President and General Counsel to the Securities Industry Association (202 216-2045), or Edward J. Rosen of Cleary Gottlieb Steen & Hamilton LLP (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 consult with staff of the Agencies in connection with staffs' efforts to finalize the Revised 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
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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
100 F Street, NE
Washington, D.C. 20549-1090

Attention: Nancy M. Morris, Secretary