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Ms. Jennifer J. Johnson  
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Mr. Robert E. Feldman  
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Regulation Comments  
Chief Counsel's Office  
Office of Thrift Supervision  
1700 G Street, NW  
Washington, DC 20552

Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

Re: Proposed Interagency Statement on Sound Practices Concerning  
Complex Structured Finance Activities

Office of the Comptroller of the Currency -- Docket # 04-12  
Office of Thrift Supervision -- Docket # 2004-27  
Board of Governors of the Federal Reserve System -- Docket # OP-1189  
Federal Deposit Insurance Corporation -- Comments/OES  
Securities and Exchange Commission -- File # S7-22-04

Ladies and Gentlemen:

Citigroup Inc. appreciates the opportunity to comment on the proposed "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities" (the "*Proposed Statement*") issued by the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission (collectively, the "*Agencies*").

Citigroup supports the efforts of the Agencies to provide guidance regarding those policies, procedures and practices that can assist financial institutions in mitigating the risks arising from "complex structured finance transactions" ("CSFTs"), while at the same time recognizing that innovative and sophisticated financing techniques, including CSFTs, have an important role to play in international capital markets. In addition, we see the Proposed Statement as an effective tool to preserve the integrity of international capital markets and to employ more generally the important lessons learned by the industry and the Agencies from recent events.

Within the context of these goals, we offer these comments in an effort to clarify the Agencies' objectives and to raise constructively any issues with the Proposed Statement that may be inconsistent with the Agencies' achievement of such objectives.

### **I. Definition of a CSFT**

The key question for any financial institution's procedures, controls and systems will be to define those transactions that are CSFTs and that, consequently, must be subjected to the enhanced scrutiny suggested under the Proposed Statement. The scope of the definition will affect the applicability of all other portions of a financial institution's new or modified policies, procedures and controls. In fact, we believe that, if the definition of a CSFT could be brought more closely in line with the Agencies' objectives under the Proposed Statement, a number of our other concerns would be minimized.

The definition proposed by the Agencies, as set forth in the first paragraph under Section II of the Proposed Statement, is broad and could potentially apply to a significant majority of the transactions in which large financial institutions engage. In general, we suggest that the language in the Proposed Statement strengthen the flexibility that the Agencies have alluded to in the Proposed Statement<sup>1</sup> and more explicitly permit each institution to establish its own definition of a CSFT, consistent with the Agencies' guidance.

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<sup>1</sup> The Agencies have stated that policies and procedures applicable to CSFTs "should start with *the financial institution's* definition of what constitutes a" CSFT (emphasis added) and that the criteria set out in the definition section of the Proposed Statement "are not exclusive and institutions should supplement or modify these criteria as appropriate to reflect the institution's business activities and changes in the marketplace." Proposed Statement, Section III, subsection "Policies and Procedures", first paragraph; Proposed Statement, Section II, first paragraph.

In general, one theme that transcends our specific comments is the need for the Proposed Statement to provide financial institutions flexibility to develop their own policies and procedures. To that end, we agree with the concerns of several of the trade associations that the Proposed Statement can currently be read to be too "prescriptive" or to be an examination "checklist" of required procedures and controls.

More specifically, we also believe that the goals of the Agencies may be better achieved if the definitional guidance were more precisely focused on those situations and transactions that serve as the impetus for the Proposed Statement.

First, we agree with the Agencies that a “limited number” of CSFTs actually present the risks that the Proposed Statement is designed to address.<sup>2</sup> Moreover, the stated objective of the Proposed Statement is to address the risks presented by certain CSFTs that have placed “pressure” on tax, accounting and regulatory rules or guidance.<sup>3</sup> Therefore, we recommend that the Agencies’ definition be more narrowly focused and that each of the first three elements (of the four definitional “characteristics” outlined in the first paragraph under Section II of the Proposed Statement) indicate that the characteristic described is “purposefully designed in order to achieve a specific tax, accounting, or regulatory goal of the counterparty.”

Second, we suggest removing the fourth “characteristic.” We believe that the characteristic does not assist in determining what CSFTs are, but only why financial institutions should be concerned about them.

Third, we are concerned that the guidance regarding the definition of a CSFT is made somewhat unclear by the language in Section III, in the subsection entitled “Reputational and Legal Risk.” This subsection lists additional characteristics of CSFTs that may signal when a CSFT requires more “enhanced” scrutiny than, presumably, a “standard” CSFT. Some of the characteristics describing this subset of CSFTs overlap with the four elements described in Section II, and, similarly, are too broad and could describe a number of ordinary course transactions at financial institutions. We also believe that the “enhanced scrutiny” described for this subset of CSFTs is not very different from the scrutiny generally required of CSFTs pursuant to the subsections entitled “Role of Board and Management,” “Policies and Procedures,” “Transaction Approval,” and “New Product Policies.”

To clarify the Agencies’ objectives, we recommend that the Proposed Statement not create different subsets of CSFTs. The “characteristics” in the “Reputational and Legal Risks” subsection would better serve the Agencies’ objectives as examples of the questions that a financial institution should ask when identifying, assessing and managing risks in all transactions that have already met the CSFT definition.

## **II. Materiality Standards**

We also believe that certain standards of materiality should be taken into account throughout the Proposed Statement.

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<sup>2</sup> Proposed Statement, Section I, second paragraph; Supplementary Information, Section I, fourth paragraph.

<sup>3</sup> Proposed Statement, Section I, second paragraph.

Although the Agencies state in the Supplementary Information that “policies and procedures concerning complex structured finance activities should be tailored to, and appropriate in light of, the institution’s size and the nature, scope and risk of its complex structured finance activities,”<sup>4</sup> for the most part the Proposed Statement presents a set of standards for policies, procedures and controls that could be construed to apply regardless of determinations as to the materiality of either the risks of the transaction or the transaction to the counterparty.

We believe that clarification could generally be accomplished by shifting the statement cited above from the Supplementary Information into the Proposed Statement and by adding a statement similar to the following: “Each financial institution’s policies and procedures should be appropriate for the types of risks involved, the financial institution’s role in the transaction and the materiality of the transaction to the counterparty.”<sup>5</sup>

### **III. The Role of Board and Management**

We concur with the Agencies’ proposed statement that a financial institution’s board of directors should establish the financial institution’s “threshold for the risks associated with” CSFTs.<sup>6</sup> However, we believe that the Proposed Statement should recognize that this is accomplished principally through the board’s review of the institution’s risk control framework, the board’s review of the way in which the institution assures that such framework has sufficient and effective risk identification and control procedures, and the board’s endorsement of the financial institution’s senior management. In other words, we believe that the use of the word “threshold” may create the implication that the board should establish some quantitative method of measuring legal and reputational risk. Given the nature of legal and reputational risk, we believe that a “threshold” for risk is not quantitative, but present in the degree to which a financial institution’s policies and senior management effectively identify and control risks.

In addition, we concur with the Agencies’ observation that a senior management committee that is involved in the oversight of CSFTs and CSFT policies for the institution as a whole can play an important role in a financial institution’s control infrastructure. The Proposed Statement may be read to imply, however, that a financial institution should establish a single such committee and that such committee should also be involved in the approval of certain

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<sup>4</sup> Supplementary Information, Section II, seventh paragraph.

<sup>5</sup> In addition to the definitional issues discussed in Section I of this letter, we note that materiality to the counterparty of a CSFT should be taken into account when defining a CSFT in order to limit appropriately the breadth of the Agencies’ proposed definition.

<sup>6</sup> Proposed Statement, Section III, subsection “Role of Board and Management,” first paragraph.

CSFTs.<sup>7</sup> We request that the Agencies' clarify that financial institutions (particularly large institutions) can utilize several such committees with different purposes, that such committees may be broken down by business line, and that the most senior of such committees need not be involved in approval of specific transactions.

#### **IV. Documentation Standards**

We agree with the Agencies' concern regarding maintenance of proper documentation for CSFTs. Well-developed standards for documentation, especially those that provide the ability to track and monitor the transaction approval process, are important internal controls.

However, as with our suggestions to clarify the definition of CSFTs, we generally believe that the document generation and retention regime proposed by the Agencies is overly broad and potentially cumbersome. We recommend that the Proposed Statement's document generation, distribution and retention standard incorporate the concept of materiality, such that "milestone" documents, or those documents, communications or analyses that describe the conclusion of an issue, are appropriately maintained.

In addition, we have several comments on the more specific aspects of the documentation standards.

First, the Agencies have suggested that financial institutions should maintain, "comprehensive documentation" for "all transactions approved, as well as disapproved transactions with controversial elements."<sup>8</sup> However, we note that transactors are continually developing ideas for transactions and these ideas can be rejected almost anywhere in the development process. Not all transactions are sufficiently developed or reviewed to warrant document retention. Also, potentially "controversial elements" that may exist in prior iterations of a proposed transaction may be completely eliminated in its ultimate form and, thus, the earlier documentation would be irrelevant and potentially confusing.

As an alternative to the standard in the Proposed Statement, we propose that, subject to the other modifications discussed in this letter, the Agencies retain the documentation requirements for transactions that are executed by the financial institution. For transactions that are not executed, whether approved or not approved, the financial institution should only be required to maintain records for those transactions that have been submitted for final approval to the relevant senior management committee.

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<sup>7</sup> Proposed Statement, Section III, subsection "Role of Board and Management," second paragraph.

<sup>8</sup> Proposed Statement, Section III, subsection "Documentation Standards," first paragraph.

Second, the Agencies apply the Proposed Statement's documentation standards to "informal" documents.<sup>9</sup> We believe that there is a significant risk of the Proposed Statement discouraging or inhibiting the creation of "informal" documents (ranging from notes to draft proposals). Such a policy could negatively affect internal discussion of the factors and risks that the Agencies want financial institutions to consider under the Proposed Statement. We do not believe that such an effect is consistent with the Agencies' objectives for the Proposed Statement. We would suggest that, subject to other applicable legal or regulatory requirements, the documentation standards be limited to more formal analyses or opinions prepared for the control functions in approving a transaction.

Third, with regard to the preservation of "[i]nternal and external correspondence, including electronic communications, regarding transaction development and due diligence,"<sup>10</sup> we ask that the Agencies clarify that this standard was not intended to subject non-broker-dealers to requirements similar to that of the SEC's Rules 17a-3 and 17a-4. Again, we believe some materiality standard is appropriate and the requirement should pick up only significant or material correspondence with a client as it pertains to a transaction's development.

Fourth, we suggest that the Agencies remove the requirement to maintain "minutes of critical meetings with clients."<sup>11</sup> The requirement could impede the normal flow of information between financial institution and client and would place a significant burden on the control functions to determine the meaning of "critical." We believe that the Agencies have captured the relevant information regarding client communications in the other documents described in the Proposed Statement.

Fifth, similar to our other comments above, the concept of a single specialized documentation unit may not be practicable for large institutions.

Sixth, the Proposed Statement should recognize that financial institutions may determine for themselves an appropriate document retention timeframe, subject to any applicable legal or regulatory requirements.

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<sup>9</sup> Proposed Statement, Section III, subsection "Documentation Standards," third paragraph, first bullet, second sub-bullet.

<sup>10</sup> Proposed Statement, Section III, subsection "Documentation Standards," third paragraph, first bullet, fourth sub-bullet.

<sup>11</sup> Proposed Statement, Section III, subsection "Documentation Standards," third paragraph, first bullet, sixth sub-bullet.

## **V. Independent Monitoring, Analysis and Compliance with Internal Policies**

We agree with the need for a strong compliance function in financial institutions engaged in CSFTs and the need to develop and enforce procedures to conduct periodic independent reviews of such activity. At the same time, if the Agencies intend the Proposed Statement to mean that such function resides exclusively with "compliance management,"<sup>12</sup> we respectfully disagree. We believe, again, that flexibility is important and that the Agencies could allow this function to be performed by the independent control function deemed most suitable by the financial institution. Certain internal functions, such as legal, accounting policy, independent risk management and tax, are independent and may be technically better equipped with product and customer expertise than the formal compliance unit. Indeed, in some institutions, policy development often occurs in the legal, risk or other control functions. In addition, after the passage of the Sarbanes-Oxley Act, business and control function management have been required to perform self-assessments that provide information necessary to understand adherence to the institution's policies and procedures. Internal audit independently should undertake periodic assessments of these control processes and reports on their effectiveness. If the intent of the Agencies were to house additional independent reviews solely in the compliance function in all institutions, we respectfully submit that such a prescription would create additional cost and bureaucracy without a corresponding benefit to those financial institutions that already conduct independent reviews through other control functions.

## **VI. Audit**

We agree that the internal audit department of any financial institution is integral to its defense against various risks and that it is imperative that this function be staffed with personnel that have the necessary skills and experience to identify and report on compliance with the institution's policies and procedures. The Proposed Statement contains a suggestion, however, that financial institutions should retain outside consultants, accountants or lawyers to review the structured product area. While this may be appropriate in certain institutions or under some circumstances, large financial institutions (to which the Proposed Statement is primarily directed) usually find it practical to use in-house expertise. The audit function is independent in its mandate and is at liberty to determine if the use of outside consultants is required in any given circumstance. We recommend that the Proposed Statement allow a financial institution the flexibility to determine for itself the extent, if any, of the involvement of outside advisors.

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<sup>12</sup> Proposed Statement, Section III, subsection "Independent Monitoring, Analysis, and Compliance with Internal Policies," first paragraph.

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**VII. Trade Association Comment Letters**

We have reviewed and we generally endorse those comment letters submitted to the Agencies by trade associations of which, we or one of our affiliates is a member, including the Clearing House, the Financial Services Roundtable, the Bond Market Association, the Securities Industry Association and the International Swaps and Derivatives Association.

Thank you for the opportunity to comment on the Proposed Statement. Please feel free to contact me at (212) 559-5152 if you have any questions or comments.

Sincerely,

A handwritten signature in black ink, appearing to be 'MSH', with a long horizontal flourish extending to the right.

MSH:aab