

CORPORATE FINANCE BULLETIN

December 2003

CIBC BANNED FROM CERTAIN STRUCTURED FINANCE TRANSACTIONS

The meaning of lender liability has changed significantly since the implosion of financial giants Enron and Worldcom. Their collapse spawned an ongoing search for parties who could be blamed and Canadian banks have been caught in the ever-widening net of lender liability that now extends beyond the architects of structured finance transactions to include lenders who merely participated in those transactions. In the past two months alone, court-appointed examiners investigating Enron's failure have singled out two Canadian banks in the investigation for allegedly "aiding and abetting" those behind the Enron fraud and on December 22, 2003 the US Securities and Exchange Commission ("SEC") announced that it had reached a settlement with the Canadian Imperial Bank of Commerce ("CIBC") regarding Enron related allegations.

CIBC entered into agreements with regulators on both sides of the border in order to settle allegations made by the SEC that it helped Enron mislead investors. CIBC paid US\$80 million and, with no admission of liability, consented to a final judgement permanently enjoining it from future violations of the antifraud, books and records, and internal control provisions of US securities laws.

One portion of the settlement entailed a separate agreement (the "Settlement Agreement") between CIBC, the Office of the Superintendent of Financial Institutions (Canada) ("OSFI"), and the Federal Reserve Bank of New York ("Fed"). In an unusual move, OSFI and Fed prohibited CIBC from engaging in certain transactions and misleading practices and required that an independent auditor be appointed to monitor compliance with a new set of policies and procedures.

OSFI finds authority for the Settlement Agreement in the *Bank Act* (Canada), which permits OSFI to enter into such a "prudential agreement" with a bank "for the purposes of implementing any measure designed to maintain or improve its safety and soundness."

SUMMARY OF SETTLEMENT AGREEMENT

The following are the key components of the Settlement Agreement:

Independent Auditor to Monitor Compliance

New policies and procedures will:

- be adopted and implemented by February 27, 2004; and
- include independent auditing for the next three years with a plan (submitted within the next 30 days) for auditing, monitoring for compliance, and reports to OSFI and Fed.

GENERAL PROHIBITIONS AND RULES

Structured Finance:

For a period of three years, CIBC cannot engage in "certain structured finance transactions" on behalf of any third party (defined as a US public company and its affiliates). These transactions are defined as follows:

- the structuring or arranging of, or investment in, the equity component necessary to achieve FAS 125 and/or 140 off-balance sheet treatment;

- the structuring or arranging of, or investment in, tax-structured lease financings for third parties; and
- the sponsoring and administration of US, U.K., and Australia based receivables conduit vehicles (provided that such conduits may be wound down or sold in an orderly fashion in the normal course of business).

Misleading Third Party Activities:

Transactions where CIBC knows or believes that an objective of the third party is to achieve a misleading earnings, revenue or balance sheet effect are banned. These transactions specifically include the following:

- **Undocumented Agreements** in which any term of the transaction related to risk transfer is not reflected in the written contractual documentation for the transaction; and
- **Transactions with Agreed-Upon Early Termination** where there is an agreement between the parties to unwind prior to the transaction’s stated maturity at an agreed-upon price. (Such transactions are permitted only if CIBC accurately reflects the agreed-upon unwind on its books and records and provides a written summary directly to the independent auditor of the third party.)

Individual Accountability

CIBC employees proposing or approving the bank’s participation in any transaction covered by the new policies shall satisfy themselves that they are “fully knowledgeable about all terms and agreements related to such transactions and that all applicable provisions of these policies and procedures and other CIBC policies and procedures have been fulfilled prior to execution.”

Special Restrictions Applicable to Quarter-End and Year-End Transactions

Quarter-End or Year-End transactions where CIBC knows or believes that the third party’s primary motivation is to achieve accounting (including off-balance sheet treatment) objectives are banned unless specifically approved by a new committee to be known as the Financial Transaction Oversight Committee (“FTOC”).

New Committee to Review Certain Transactions

The FTOC will be created from senior representatives of various disciplines of CIBC to review the following:

- Quarter-End and Year-End Transactions;
- all “complex structured finance transactions” effected by a third party with CIBC specifically where:
 - i. a known or believed material objective is to achieve a particular accounting or tax treatment, including the objective of transferring assets off-balance sheet;
 - ii. there is material uncertainty with regard to the legal or regulatory treatment of such transaction; or
 - iii. the transaction provides the third party with the economic equivalent of a financing which, if characterized as a financing, would require committee approval;
- all early unwinds or termination prior to originally contemplated maturities of complex structured finance transactions and Quarter-End or Year-End transactions; and
- any transaction a member of the FTOC determines appropriate for review.

FTOC Purposes Include:

- the effective management of all risks associated with transactions within its purview, including an assessment of legal and reputational risk with respect to each transaction;
- referral of any suspicious transaction to the US Department of Justice monitor;
- requiring each transaction to be sponsored by a person representing that they are “providing complete and accurate information regarding the transaction and the third party’s purpose(s) for such transaction”; and

- communicating full descriptions of each approved transaction to the independent auditor of the applicable third party regardless of any request for the information.

Employee Training and Reporting

- The existing training program will be reviewed and modified to ensure compliance with the new policies and procedures.
- An internal “Policy and Approval Process Website” will be developed to allow employees to communicate with the FTOC.
- An “Ethics Hotline” will be established to report inappropriate behavior and/or any failure to properly abide by the new policies.

IMPLICATIONS FOR CANADIAN BANKS

The Settlement Agreement demonstrates that financial regulators are adopting a much tougher stance with respect to Enron-style transactions. In addition to extracting significant penalties and banning individual employees from holding senior positions at public companies, the regulators have restricted CIBC from participating in certain segments of the market. This exclusion remedy may involve an opportunity cost that is at least as significant as the financial penalty imposed on CIBC. Personal liability has also been extended. No longer limited to retail brokers, personal liability may now extend to investment bankers who pursue aggressive financial structures.

The time limited ban on CIBC suggests that the transactions in question are not offensive per se and may continue to be pursued by other banks. The misleading activities targeted by OSFI, on the other hand, clearly indicate that financial regulators frown upon side agreements and any artificial unwind mechanisms, practices that should be avoided by Canadian banks in the future. At a minimum, Canadian banks can be expected to adopt tougher internal review procedures for structured finance transactions and may not in the future be as willing to act as accommodation parties to assist their corporate clients to achieve goals that could mislead investors.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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