

Financial Services Alert

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Developments of Note

➤ **Department of the Treasury Issues Blueprint for a Modernized Financial Regulatory Structure**

The U.S. Department of the Treasury (the “Treasury”) issued a three-stage plan (the “Plan”) to reform government regulation of financial institutions.

Short-Term. The Treasury recommends, among other things, that, in the short term: (1) the President’s Working Group on Financial Markets be expanded to broaden its focus and to include representatives from the whole financial sector; (2) the creation of a new Federal Commission for Mortgage Origination to set minimum licensing standards and to evaluate each state’s licensing system; and (3) the FRB’s powers be expanded so that it can examine and impose conditions on non-bank institutions who have temporary access to FRB lending.

Intermediate-Term. In the intermediate term, the Plan recommends, among other things: (1) the elimination of the federal thrift charter and the merger of the OTS into the OCC; (2) that federal supervision of state-chartered banks be assigned, after a study, to either the FRB or the FDIC; (3) that a new charter for systemically-important payment and settlement systems be created, and that the FRB have primary oversight of such entities; (4) that an optional federal insurance charter be created and that entities choosing the federal insurance charter be supervised by a new Office of National Insurance within Treasury; and (5) that the SEC and CFTC be merged.

Optimal Long-Term. The Plan proposes a revamped financial regulatory system for the long term that would use an “objectives-based approach for optimal regulation” and under which financial institutions

would be offered one of three federal charters: (a) a Federal Insured Depository Institution charter for lenders with federal deposit insurance; (b) a Federal Insurance Institution charter for insurers offering retail products where some federal guarantee is present; and (c) a Federal Financial Services Provider charter for all other federally-chartered institutions.

To implement these long term objectives, Treasury proposes in the Plan that three distinct regulators would focus exclusively on financial institutions:

(i) a *market stability regulator* (the FRB with expanded authority) would gather information, disclose information, collaborate with other regulators on rule writing and take corrective action, as needed, to protect financial market stability. The market stability regulator would have the authority to monitor risks across the financial system (including risks at mortgage companies, hedge funds, etc.).

(ii) a *prudential regulator* (that would assume most of the current roles of the OCC, OTS and NCUA) would focus on safety and soundness of entities with federal guarantees and would have authority to address affiliate relationship issues. The prudential regulator would apply capital adequacy requirements, investment limits, activity limits and risk management supervision.

(iii) a *business conduct regulator* (assuming most roles of the SEC and CFTC and some roles of the current bank regulatory agencies, the FTC and state insurance agencies) would monitor business conduct regulation (e.g., consumer protection and mortgage and product disclosure, fair business practices, licensing).

In addition, the Plan envisions a Federal Insurance Guarantee Corporation that would assume the FDIC's role as insurer and charge premiums to guarantee deposits and insurance products. Moreover, a Corporate Finance Regulator would assume certain SEC functions including, among other things, oversight of corporate disclosures and corporate governance.

The Treasury recognizes that the proposals in the Plan are unlikely to be adopted during the Bush Administration or soon thereafter, but Treasury Secretary Paulson has stated that he hopes that they will be the basis for consideration of financial regulatory reform during the next administration. Moreover, it is clear that many of these proposals will spur substantial debate. Goodwin Procter's Financial Services Group will monitor closely the debates on the proposals in the Plan and will report on important developments that arise out of the Treasury's proposals.

➤ **SEC Proposes to Permit ETFs to Operate Without Individual Exemptive Relief and to Increase the Extent to which Other Registered Funds May Invest in ETFs**

The SEC issued a formal release proposing a new rule and rule amendments that would greatly ease the process of bringing new exchange traded funds ("ETFs") to market and increase the ability of other funds to invest in ETFs. The proposed rule amendments would, to a large extent, codify the terms of SEC exemptive relief that is currently necessary for ETFs to commence operations and would revise open-end fund prospectus disclosure requirements to improve the usefulness of ETF prospectuses to investors who received them in connection with their purchases of ETF shares in the secondary market. The rule amendments also include revisions to Rule 12d1-2 under the Investment Company Act of 1940, as amended (the "1940 Act"), that address questions raised about the extent to which the rule allows an affiliated fund of funds to invest in other assets.

Proposed Rule 6c-11

Proposed Rule 6c-11 under the 1940 Act would generally codify exemptive relief that the SEC has provided in the past to allow index based ETFs and actively managed ETFs to operate. ETFs are investment companies that are typically registered under the 1940 Act as open-end funds. Unlike typical open-end funds, ETFs do not sell or redeem their individual shares at net asset value ("NAV"). Instead, they sell and redeem shares at NAV only in large blocks (such as 50,000 shares), which are

typically referred to as “Creation Units.” Purchases and redemptions at NAV are effected in-kind through the tender of a basket of securities designated by the ETF based on its portfolio holdings. National securities exchanges list ETF shares for trading, which creates a secondary market where ETF shares can trade at negotiated prices in non-Creation Unit quantities. The arbitrage activity engaged in by large institutional investors buying and redeeming Creation Units in response to changes in an ETF’s market price relative to its NAV is supposed to minimize differences between an ETF’s NAV and its market price. Because their operations do not conform to the limitations for any of the types of registered collective investment vehicles permitted under the federal securities laws, each ETF has had to obtain specific exemptive relief from certain provisions of the 1940 Act before commencing operations. If Rule 6c-11 is adopted, an ETF that complies with the rule’s conditions may commence operations without going through the expense and delay of securing an SEC exemptive order.

Index Based and Actively Managed ETFs Permitted. The SEC has, until recently, granted the necessary exemptive relief only to index based ETFs that seek to track the performance of a specified domestic or foreign market index. In late February 2008, the SEC granted the first exemptive relief for actively managed ETFs, whose securities selection is based on their particular investment objectives and policies rather than the composition of an index (see the March 4, 2008 *Alert* for more on those exemptive orders). The proposed rule would permit both index based and actively managed ETFs. An index based ETF relying on the proposed rule would have to seek returns that correspond to those of an index whose provider discloses the identities and weightings of the index’s component securities and other assets on its Internet website each business day. The proposed rule would not limit the types of indices on which an ETF could be based. Consequently, although existing ETFs have generally represented to the SEC that their portfolios consist of highly liquid securities or assets, an index based ETF relying on the proposed rule would not have to use an index containing only liquid securities or assets. However, because investment companies relying on Rule 6c-11 would have to register as open-end investment companies, an index based ETF would be subject to the same 15% of assets limitation on illiquid securities as other open-end investment companies. An actively managed ETF relying on the proposed rule would have to disclose on its Internet website each business day the identities and weightings of its portfolio securities.

Listing on National Securities Exchange. An ETF relying on proposed Rule 6c-11 would have to be listed on a national securities exchange which disseminated the intra-day value of the ETF’s portfolio at regular intervals; the proposed rule does not specify the frequency of such disclosures, which would be specified under the rules of the particular national securities exchanges on which the ETF was listed. The proposed rule does not require disclosure of intra-day changes in an ETF’s portfolio.

Conflicts of Interest and Affiliated Transaction Relief. The proposing release notes that Rule 6c-11 does not address the situation where an ETF’s adviser includes in the basket of securities designated for Creation Unit purchases securities that a party purchasing shares at NAV from ETF would have to buy from an affiliate of the adviser. The proposing release observes that such actions would be inconsistent with Section 48 of the 1940 Act, which prohibits doing indirectly what the 1940 Act prohibits doing directly (in this case, violating the affiliated transaction prohibitions of Section 17(a) of the 1940 Act). Similarly, the proposed rule does not include conditions found in ETF exemptive orders designed to prevent misuse of non-public information where the index provider for an ETF is an affiliate of the ETF’s adviser; the proposing release states that existing prohibitions on the misuse of insider information already address those issues. The proposed rule does provide relief from the prohibitions of Section 17(a) to allow affiliated persons of an ETF to engage in the in-kind transactions with the ETF that are part of the process of purchasing and redeeming shares in Creation Unit quantities, except when a fund is redeeming ETF shares that it acquired in reliance on proposed Rule 12d1-4 (as discussed below).

Statutory Prospectus Delivery Requirements. Under prior exemptive relief for ETFs, broker-dealers have not been required to deliver a statutory prospectus when they sell ETF shares in most secondary market transactions. Instead, in accordance with the rules of the national securities exchanges which have listed ETFs for trading, broker-dealers have had to deliver a “product description,” which provides

a summary of the basic features of the ETF and its shares, including investment objectives, the manner in which its shares trade in the secondary market and the manner in which Creation Units are purchased and redeemed. The SEC's understanding is that broker-dealers have, in fact, been using the statutory prospectus rather than a product description to fulfill these obligations to secondary market purchasers.

Rule 6c-11 does not include relief from the statutory prospectus delivery requirements for secondary market sales by broker-dealers. Furthermore, the proposing release indicates that if Rule 6c-11 is adopted, the SEC would amend existing orders for open-end fund ETFs to eliminate relief previously granted from the statutory prospectus delivery requirements. The SEC envisions that the summary prospectus it has proposed in separate rulemaking, a much briefer document than the statutory prospectus, could be used to satisfy the prospectus delivery obligation that would apply to a broker-dealer's secondary market sales of ETF shares after Rule 6c-11's adoption (for more detail on the SEC's summary prospectus proposal see the Goodwin Procter *Client Alert* at <http://www.goodwinprocter.com/~media/AEF906C8F8A74A778EA9C7E7D8E2A0FC.ashx>). The proposing release indicates that if the SEC adopts Rule 6c-11 prior to action on the summary prospectus proposal, it would allow use of the product description to satisfy prospectus delivery requirements in the interim.

Form N-1A Amendments

The changes to Form N-1A disclosure requirements being proposed in connection with Rule 6c-11 are designed to focus the disclosure provided in open-end fund prospectuses on the needs of secondary market investors in ETFs, who will be receiving statutory prospectuses if Rule 6c-11 is adopted, rather than on Creation Unit investors. (Form N-1A is the registration form for open-end investment companies). The changes proposed by the SEC would

- (a) modify the purchase and sale instructions and information provided in the Form N-1A prospectus and statement of additional information,
- (b) add total return based on market price to the prospectus's annual return table,
- (c) require an index based ETF to compare its performance to that of its underlying index (as opposed to a broad-based securities market index) and
- (d) add information regarding the historical premium/discount of an ETF's market price to its NAV.

These changes would appear in the section of the N-1A prospectus that would also constitute the proposed summary prospectus. As a result, if the SEC adopted both its ETF and summary prospectus proposals, broker-dealers could satisfy the prospectus delivery requirements that would apply to secondary market transactions in ETFs with their customers by providing either a statutory prospectus or summary prospectus, each of which would contain the new disclosures. The SEC's proposal would also revise the shareholder report disclosure requirements for open-end funds to include corresponding changes to total return and index return disclosures and add historical premium/discount information.

Investments in ETFs by Other Registered Funds

The ability of registered funds to invest in ETFs is limited by Section 12d(1) of the 1940 Act. Proposed Rule 12d1-4 would allow registered funds to acquire ETF shares in excess of those limits. The conditions on the proposed rule's relief would be fewer than those imposed under prior SEC exemptive relief, but unlike the prior relief, the proposed rule would limit the ability of an acquiring fund to redeem ETF shares acquired in reliance on the proposed rule. Proposed Rule 12d1-4 would also provide relief from the affiliated transaction prohibitions of Section 17(a) of the 1940 Act to allow an acquiring fund that was an affiliated person of an ETF, *e.g.*, because the acquiring fund owned 5% or

more of the ETF's outstanding voting securities, to engage in otherwise prohibited in-kind Creation Unit purchase and redemption transactions with that ETF. Reliance on the proposed rule would be subject to the following conditions:

- *Control* – An acquiring fund and any of its investment advisers or depositors, and any company in a control relationship with any of them (*i.e.*, that controls, is controlled by or is under common control with any of them), each individually or in the aggregate, could not control an ETF within the meaning of the 1940 Act; and if, as a result of a decrease in the outstanding voting securities of an ETF, any of the foregoing, either individually or together in the aggregate, became holders of more than 25 percent of the outstanding voting securities of that ETF (*i.e.*, were presumed to control the ETF), each of those shareholders would have to vote its shares of the ETF in the same proportion as the vote of all the ETF's other shareholders. This condition mirrors a condition in the SEC's prior ETF exemptive orders.
- *Redemption Limitation* – An acquiring fund that relies on the proposed rule to acquire shares of an ETF in excess of the Section 12(d)(1)(A)(i) limit (*i.e.*, acquires more than 3% of the ETF's shares) could not redeem those shares, with the most recently acquired ETF shares being treated as subject to redemption first. As a result, an acquiring fund could redeem shares from an ETF only when the fund (and companies or funds it controls) held ETF shares in an amount consistent with the 3% limitation in Section 12(d)(1)(A)(i). The proposed rule would not, however, prohibit an acquiring fund that relied on the proposed rule from investing in ETFs in excess of the Section 12(d)(1)(A)(ii) limit (*i.e.*, by investing more than five percent of its assets in the acquired ETF) and/or investing in all funds (including the acquired ETF) in excess of the Section 12(d)(1)(A)(iii) limit (which limits such investments to no more than 10 percent of the acquiring fund's assets), from redeeming shares of the ETF.

The proposed rule would also prohibit an ETF, its principal underwriter, and any broker-dealer that relied on the rule to sell ETF shares in excess of the Section 12(d)(1)(B) limits, from redeeming (or submitting an order to redeem) those shares acquired by the acquiring fund in excess of the 3% limit in Section 12(d)(1)(A)(i). The proposed rule includes a safe harbor that is available if the entity: (i) has received a representation from the acquiring fund that none of the ETF's shares the acquiring fund is redeeming includes any shares that it acquired in excess of 3% of the ETF's shares in reliance on the proposed rule; and (ii) has no reason to believe that the acquiring fund is redeeming ETF shares that the acquiring fund acquired in excess of 3% of the ETF's shares in reliance on the proposed rule.

The proposing release notes that the adoption of proposed Rule 12d1-4 would not preclude an acquiring fund from continuing to rely on exemptive orders the SEC has previously issued that permit funds to invest in ETFs in excess of Section 12(d)(1) limits without restricting their ability to redeem ETF shares, and that the SEC intends to continue to issue those orders and may consider codifying them in the future.

- *Prohibition on Multi-Tier Structures* – The proposed rule would prohibit an ETF whose shares were being acquired in reliance on the proposed rule from itself being a fund of funds by requiring the ETF to have a disclosed policy that prohibits it from investing more than 10 percent of its assets in: (i) other investment companies in reliance on Section 12(d)(1)(F) or Section 12(d)(1)(G) of the 1940 Act or the proposed rule, and (ii) any issuer relying on the exceptions from the definition of "investment company" in Sections 3(c)(1) and 3(c)(7) of the 1940 Act.
- *Limits on Layering of Fees* – Under the proposed rule, sales charges (including any 12b-1 fees) and service fees charged by an acquiring fund would have to comply with the limits applicable to funds of funds under NASD Conduct Rule 2830(d)(3). The proposed rule includes additional provisions that address fees charged by separate accounts that invest in acquiring funds.

- Because an acquiring fund could become a second tier affiliate of a broker-dealer affiliated with an ETF by owning 5% or more of the ETF's outstanding voting securities, the proposed rule provides relief from certain conditions that Rule 17e-1 under the 1940 Act imposes on transactions with affiliated broker-dealers. The proposed rule would permit an acquiring fund, whose status as an affiliated person of an ETF was based solely upon a 5% or more ownership interest in the ETF, to pay commissions, fees or other remuneration to a broker-dealer that was an affiliated person of the ETF without complying with the quarterly board review and recordkeeping requirements in Rules 17e-1(b)(3) and 17e-1(d)(2). The SEC provided similar relief from Rule 17e-1 in Rule 12d1-1, which permits a registered fund to make money market fund investments in excess of Section 12(d)(1) limits.

Affiliated Funds of Fund – Investment in Unaffiliated ETFs and Other Assets

Rule 12d1-2 under the 1940 Act allows funds that invest in affiliated funds in reliance on Section 12(d)(1)(G) to also invest in (i) unaffiliated money market funds when the acquisition is in reliance on Rule 12d1-1, (ii) securities issued by unaffiliated funds (including ETFs), subject to the investment limits in Sections 12(d)(1)(A) and 12(d)(1)(F) of the 1940 Act, and (iii) securities not issued by an investment company. The SEC's proposal would amend Rule 12d1-2 to also allow investments in unaffiliated ETFs in excess of Section 12(d)(1) limits provided the investments are in compliance with the conditions of proposed Rule 12d1-4. (An acquiring fund that relies on Rule 12d1-2 may currently only acquire shares of unaffiliated ETFs consistent with Section 12(d)(1) limits (*e.g.*, no more than 3% of an unaffiliated ETF's shares)).

The SEC would also amend Rule 12d1-2 to allow funds relying on Section 12(d)(1)(G) to invest in assets or instruments other than securities. This proposal is intended to address concerns expressed following the adoption of Rule 12d1-2 that funds relying on Rule 12(d)(1)(G) might wish to invest in other types of financial assets, including futures and other financial instruments that might not be securities under the 1940 Act and thus may not be "securities (other than securities issued by an investment company)," the only category of non-investment company investments permitted under current Rule 12d1-2.

Request for Comment

The SEC has requested comment on many specific aspects of the proposed rule and rule amendments as well as on various alternatives to its proposals. Comments are due by May 19, 2008.

➤ IRS Issues Final Regulations Regarding Diversification Requirements for Variable Contracts

The IRS finalized regulations (T.D. 9385) under Section 817 of the Internal Revenue Code (the "Code") concerning the diversification requirements applicable to variable annuity, endowment, and life insurance contracts. Section 817 of the Code provides that if a variable contract based upon a segregated asset account is not adequately diversified, then such variable contract will not be treated as an annuity, endowment or life insurance contract. Additionally, any income earned by that segregated asset account will be treated as ordinary income received or accrued by the policyholders. A variable contract will be treated as adequately diversified if no one investment constitutes more than 55% of the whole value of the total assets, no two investments constitute more than 70% of the whole value of the total assets, no three investments constitute more than 80% of the whole value of the total assets, and no four investments constitute more than 90% of the whole value of the total assets. Section 817 provides for a look-through rule under which taxpayers do not treat an investment in a regulated investment company ("RIC"), partnership, or trust as a single asset, but, rather, take into account the underlying assets of the RIC, partnership, or trust. This look-through rule applies, however, only where all of the interests in the RIC, partnership or trust are owned by one or more segregated assets accounts or certain "permitted investors," and where public access to the RIC, partnership, or trust is available exclusively through the purchase of a variable contract.

The final regulations expand the list of “permitted investors” to include ownership by qualified section 529 tuition plans, by trustees of foreign pension plans, and by Puerto Rican accounts that are treated as segregated accounts under Puerto Rican law. Under the former regulations, “permitted investors” included only the general account of a life insurance company, the manager of the RIC, partnership or trust, a qualified pension or retirement plan, or certain members of the public. Additionally, the final regulations remove a provision from the regulations that provided that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on an insurance contract. Under the final regulations, the amount required to be paid to remedy an inadvertent failure to diversify remains the amount set forth on Revenue Procedure 92-25, section 4.02. However, the modification will preserve flexibility should the IRS desire to change this amount in response to future comments requested by Notice 2007-15.

The regulations were finalized in substantially the form of the regulations proposed on July 30, 2007 (REG-118719-07), and became effective on March 7, 2008.

➤ **OCC Issues Bulletin on Annual Review of Fiduciary Accounts**

The OCC issued a bulletin (2008-10, the “Bulletin”) concerning annual reviews of fiduciary accounts. Under OCC regulation 12 C.F.R. 9.6(c), a national bank is required to review, no less frequently than annually, all assets of each fiduciary account for which the bank has investment discretion “to evaluate whether they are appropriate, individually and collectively, for the account.”

Elements of an Effective Annual Investment Review Process. The Bulletin states that a national bank’s annual investment review process should: (1) ensure that investment objectives are current and appropriate and that the investments are consistent with these objectives; (2) ensure that the review covers all assets in the investment portfolio; (3) identify and track exceptions and provide for follow-up and resolution of exceptions; (4) include performance measurements and a process for handling performance “outliers”; and (5) ensure that each asset is valued using an appropriate valuation process. The Bulletin stresses the need for thorough documentation of all reviews.

Unique or hard-to-value assets (*e.g.*, real estate, oil interests, farms, closely held businesses) should be included in the annual review. Moreover, the bank’s review should document the bank’s determination that the asset is appropriate given the account’s investment objectives, should provide updated asset valuations appropriate for the type of asset and the nature of the account and should ensure that proper insurance coverage is maintained on the assets.

Automated and Manual Investment Review Processes. The OCC states in the Bulletin that national banks may use manual, automated or hybrid systems to perform annual investment reviews. Manual reviews provide a more hands-on approach, but can be time-consuming and review quality may vary with the individual performing that review. Automated systems allow for efficient and frequent valuations of marketable securities and securities in collective investment funds and effective identification of exceptions to account objectives. Automated systems, however, do not provide the independent perspective provided by committee review nor will they spot when investment objectives need to be changed to reflect market changes or changes derived from the passage of time.

The Bulletin concludes by noting that the OCC expects annual investment reviews to be performed in a timely and comprehensive manner and that bank examiners will seek corrective action “for significant weaknesses or unwarranted risks” in the annual investment review process.

➤ **Federal Financial Institutions Regulatory Agencies Release Proposed Revisions to Interagency Flood Insurance Questions and Answers**

The FRB, FDIC, OCC, OTS, NCUA and Farm Credit Administration (the “Agencies”) released for comment new and revised interagency questions and answers regarding flood insurance (the “Proposed

Q&A's"). The current Interagency Questions and Answers regarding Flood Insurance were published in 1997 under the auspices of the Federal Financial Institutions Examination Council and have not been revised since that time. The Agencies propose to add a new section to address more specific circumstances that a lender may encounter when deciding whether a loan should be a designated loan for the purposes of flood insurance. The proposed changes also provide guidance as to how lenders should determine the appropriate amount of flood insurance to require a borrower to purchase. The Proposed Q&A's include a discussion of the maximum limit of coverage available for particular types of property and clarify that a lender can require more flood insurance than the minimum amount required by the current final regulations of each agency.

The Proposed Q&A's include substantive modifications to the questions and answers pertaining to construction loans and condominiums such as:

- Addressing the eligibility for flood insurance of buildings in the course of construction and the timing of when flood insurance must be purchased for such buildings;
- Addressing that the flood insurance requirements for residential condominium units are the lesser of the outstanding balance of the loan or the maximum amount of coverage available under the National Flood Insurance Program;
- Clarifying what a lender must require of a borrower if the outstanding principal balance of the loan is greater than the maximum amount of coverage available;
- Affirming that the mandatory flood insurance requirements apply to loans secured by individual residential condominium units, and;
- Addressing a lender's options when a loan secured by a residential condominium is in a multi-unit complex whose condominium association does not obtain or maintain the required amount of flood insurance.

The Agencies are further proposing new questions and answers in a number of areas, including second lien mortgages, the imposition of civil money penalties, and loan syndications and participations. The Proposed Q&A's would explain that, with respect to loan syndications and participations, individual participating lenders are responsible for ensuring compliance with flood insurance requirements. Finally, the Agencies propose to revise and reorganize certain existing questions and answers to clarify areas of potential misunderstanding and to provide clearer guidance. Comments on the Proposed Q&A's are due May 20, 2008

Other Items of Note

➤ **FINRA Issues Regulatory Notice Regarding Elimination of Principal Pre-Approval Requirement for Sales Material Previously Filed by Another Member**

FINRA issued a Regulatory Notice announcing the March 26, 2008 effectiveness of an amendment to NASD Rule 2210 that creates an exception to the Rule's registered principal pre-approval requirements to allow a member firm to use sales material without principal pre-approval if another firm has filed the sales material and received a letter from FINRA stating that the sales material appears consistent with applicable standards. The Regulatory Notice also announces the effectiveness of an amendment to NASD Rule 2210 that codifies the FINRA staff interpretation that a firm must maintain records of advertisements, sales literature and independently prepared reprints for a period beginning on the date of first use and ending three years after the date of last use. See the January 15, 2008 *Alert* for a more detailed discussion of these amendments.

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➤ **FINRA Issues Annual Examination Priorities Letter**

FINRA issued a letter to its members highlighting new and existing priorities for FINRA's 2008 examination program. The letter also discusses procedural changes for the examination process and certain FINRA resources available to member firms.