

Financial Services Alert

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Developments of Note

➤ **SEC Staff Provides No-Action Relief from 1940 Act Affiliated Transaction Prohibitions to Permit Restructuring of Asset Allocation Funds into Fund-of-Funds Through In-Kind Transfers**

The staff of the SEC's Division of Investment Management (the "Staff") recently provided a further extension of the no-action relief that it has provided in the past from the affiliated transaction prohibitions of Section 17(a) of the Investment Company Act of 1940, as amended (the "1940 Act"), for in-kind transactions undertaken as part of mutual fund restructurings. (For a discussion of the past relief, see the December 4, 2007 *Alert* discussing *Old Mutual Advisor Funds* (pub. avail. Nov. 16, 2007) ("*Old Mutual*") and the January 16, 2007 *Alert* discussing *Gartmore Variable Insurance Trusts* (pub. avail. Dec. 29, 2006)). The most recent no-action relief was provided to permit restructuring transactions in which certain asset allocation funds (the "Asset Allocation Funds") sought to convert to a fund-of-funds structure relying on Section 12(d)(1)(G) of the 1940 Act through in-kind transfers of their portfolio securities, rather than cash transactions, to avoid the additional costs associated with the latter. (Section 12(d)(1)(G) permits a fund-of-funds structure where the underlying funds are part of the same "group of investment companies.") The Asset Allocation Funds operate by allocating their assets among various sleeves (each, a "Sleeve") representing different investment mandates. The proposed conversion of the Asset Allocation Funds to a fund-of-funds structure would result in the Asset Allocation Funds' various Sleeves investing directly in certain affiliated mutual funds with the same or substantially similar mandates (the "Transferee Funds," and, together with the Asset Allocation Funds, the "Participating Funds"), in lieu of investing directly in securities. Although similar in many respects to *Old Mutual*, the Participating Funds' circumstances also presented several factual differences, including that the portfolio securities in each Sleeve had not been segregated on the books of the Asset Allocation Fund's custodian, fund accounting agent and sub-administrator.

Conditions. The latest no-action relief is subject to a number of conditions that track those in the Staff's past no-action letters providing Section 17(a) relief for fund restructuring transactions, including conditions addressing (a) the lack of dilution of shareholder interests, (b) the appropriateness, in type and amount, of the in-kind consideration for investment by a Transferee Fund, (c) valuation procedures,

(d) the making of specified findings by the boards of the Participating Funds, (e) the maintenance of certain records, and (f) the investment adviser's disclosure of any conflicts of interest.

Goodwin Procter LLP represented the Participating Funds seeking the no-action relief.

➤ **IRS Issues Guidance Concerning Modification of Mortgage Loans Held by REMICs and Trusts**

The Internal Revenue Service (the "IRS") issued Revenue Procedure 2008-28 on May 16, 2008 to provide guidance on the conditions under which modifications of certain mortgage loans will not cause the IRS to challenge the tax status of real estate mortgage investment conduits ("REMICs") and investment trusts that hold the loans, or to assert that the modifications create a liability for tax on a prohibited transaction. Under the new guidance, subject to the conditions noted below, the IRS will not challenge the qualification of a REMIC on the grounds that a modification is not within certain listed exceptions provided for in Treasury Regulation Section 1.860G-2(b)(3). Additionally, the IRS will not assert that a modification is a prohibited transaction under Section 860F(a)(2) of the Internal Revenue Code, or challenge a REMIC's qualification on the grounds that a modification resulted in a deemed reissuance of the REMIC's regular interests. With respect to investment trusts, subject to the conditions noted below, the IRS will not challenge the classification of such trust on the grounds that the modification manifests a power to vary the investment of the trust's certificate holders.

Revenue Procedure 2008-28 applies to modifications of mortgage loans held by REMICs and investment trusts, if six conditions are satisfied. First, the real property securing the mortgage must be a residence that contains fewer than five dwelling units. Second, the real property securing the mortgage must be owner occupied. Third, if a REMIC holds the mortgage loan, then as of either the startup day or the end of the 3-month period beginning on the startup day, no more than ten percent of the stated principal of the REMIC's total assets may be represented by loans the payments on which were then overdue by 30 days or more; or, if an investment trust holds the mortgage loan, then as of all dates when assets were contributed to the trust, no more than ten percent of the stated principal of all the debt instruments then held by the trust may be represented by instruments the payments on which were then overdue by 30 days or more. Fourth, the holder or servicer of the mortgage must reasonably believe that there is a significant risk of foreclosure of the original loan. Fifth, the terms of the loan, as modified, must be less favorable to the holder than were the unmodified terms of the original mortgage loan. Lastly, the holder or servicer must reasonably believe that the modified loan presents a substantially reduced risk of foreclosure, as compared with the original loan.

Revenue Procedure 2008-28 is effective for determinations made by the IRS on or after May 16, 2008, with respect to loan modifications that are effected on or before December 31, 2010. The IRS is seeking public comments on this revenue procedure. Comments should be submitted no later than July 15, 2008.

➤ **FRB Discusses Bank Risk Management Concerns and Responses**

At different conferences, FRB Chairman Bernanke and Federal Reserve Bank of Boston President Rosengren spoke about risk management concerns and responses by US banking institutions and US federal bank regulators. Although Mr. Rosengren focused more on operational risk while Chairman Bernanke spoke more about risk management generally, both provided background as to the current turmoil, particularly the "originate to distribute model" of mortgage lending, and then focused attention on similar specific areas.

Risk Management Approaches. Perceived breakdowns in risk management approaches of financial institutions was an extended focus of both speakers. Chairman Bernanke noted "significant deficiencies" by banking institutions in identifying and measuring risks. He cited underestimation of the risk of subprime mortgages and structured finance products, as well as failing to recognize the linkages between credit and market risk, as prime examples. Chairman Bernanke also criticized an

overreliance on quantitative models (like Value at Risk), rather than a more multi-faceted approach to calculating risk. Mr. Rosengren highlighted that many of the problems in the current turmoil are attributable, in part, to institutions developing and applying risk models based on insufficient data regarding the originate to distribute model and larger economic changes, and failing to take a conservative approach (*e.g.*, holding more capital) in light of that limited data.

Both speakers also highlighted the inadequate stress testing done by many institutions with respect to their credit models. Mr. Rosengren noted that “none of the major stress tests I am aware of – done by a variety of financial institutions – came close to capturing the depth of problems that we are experiencing today.” He stated that most models missed many of the linkages – between lowered housing prices and default incentives, the inability of a household to pay all its debts if it could not pay its mortgage, and the liquidity concerns that would result – that are evident today. He further noted that legal risks particularly involving litigation, are among the higher risks today. Chairman Bernanke focused more on the need for organization-wide stress testing to determine risk concentrations that cut across the banking book, the securities portfolio, and counterparty exposures.

Liquidity Risk. Both speakers also focused on liquidity risk. Chairman Bernanke stated that “institutions must understand their liquidity needs at an enterprise-wide level and be prepared for the possibility that market liquidity may erode quickly and unexpectedly”. He noted that many institution treasury functions did not have sufficient data to gauge the liquidity impact of the liquidity needs of several business lines concurrently, or off balance sheet assets coming on balance sheet. Mr. Rosengren focused on how banks did not adequately evaluate the liquidity of facilities such as auction rate securities, and also did not take sufficient precautions to protect against the illiquidity created by the need to quickly unwind positions of a rogue trader.

Supervisory Responses. Chairman Bernanke also discussed the supervisory response to these issues. He stated that it is “clear that supervisors must redouble their efforts to help organizations improve their risk management practices.” Moreover, the FRB also is considering issuing further guidance on the need for an enterprise-wide perspective when assessing risk. The FRB also is working with the Basel Committee on Banking Supervision to develop enhanced guidance on management of liquidity risks and better disclosures to strengthen market discipline.

➤ **FinCEN Clarifies Anti-Money Laundering Obligations for Foreign Exchange Service Providers**

The Financial Crimes Enforcement Network (“FinCEN”) released three letters designed to clarify the status of certain foreign exchange businesses under the Bank Secrecy Act (“BSA”). Specifically, FinCEN addressed whether each of three foreign exchange parties is a “money services business” and, thereby, obligated to meet the requirements applicable to such businesses under the BSA.

In the first letter (FIN-2008-R002), FinCEN found a foreign exchange dealer to be a “money transmitter” because the dealer accepts funds from its customers and transmits funds to its customers’ third-party counterparts. FinCEN noted that the dealer’s funds movements did “not constitute an integral part of the execution and settlement of any transaction other than the [foreign exchange] funds transmission itself.” For this reason, the dealer’s activities triggered the application of FinCEN’s money transmission regulation. In so holding, FinCEN also clarified that the definition of money transmitter is not limited to those who deal with physical currency or funds.

In the second letter (FIN-2008-R003), FinCEN determined that a firm engaged in the business of foreign exchange risk management for Internet sellers also was a “money transmitter.” FinCEN reached this determination, in part, because the firm settles transactions by moving funds between its clients and the clients’ foreign suppliers and, as above, these transactions were not integral to any other transaction. At the same time, FinCEN reiterated its earlier position that the firm’s submission of bank card information of a client’s customer, which the firm has received from the client, to the card

processor for authorization and payment would not, by itself, have caused the firm to be a money transmitter.

In a final letter (FIN-2008-R004), FinCEN addressed how an intermediate foreign exchange broker should be treated under the BSA. The broker acts as foreign exchange consultant and, in some circumstances, has no involvement in the foreign exchange transaction, which is handled directly between the broker's client and an executing bank. In other situations, the broker transmits its clients' U.S. dollars to an executing bank, which will conduct the foreign exchange transaction and remit funds in the foreign currency to the counterparties of the broker's clients (without the involvement of the broker). FinCEN found that, in both circumstances, the broker is not a money transmitter. In the first case, the broker has no involvement in the funds transmission at all. In the second case, the broker is sending dollars, but only to settle a foreign exchange transaction at the executing bank that the broker has arranged.

As a result of FinCEN's letters, many foreign exchange businesses that currently are not registered with FinCEN may need to do so. A failure to register as a money services business with FinCEN has grave consequences, including potential criminal liability. 12 USC § 1960.

➤ **SEC to Consider Mandatory Interactive Data Tagging of Risk/Return Summary in Mutual Fund Prospectuses**

The SEC announced that at an open meeting on Wednesday, May 21, it will consider whether to propose that prospectuses in mutual fund EDGAR filings present risk/return summary information using interactive data format. Use of interactive data format involves data tagging or labeling information in electronic filings using standardized definitions so that the information can be retrieved, searched and analyzed through automated means. The SEC began a voluntary program in August 2007 (as discussed in the July 17, 2007 *Alert*) that has allowed mutual funds to submit data tagged information in the risk/return summary portion of their prospectuses. The SEC has posted an overview of the voluntary data tagging program for mutual funds at http://www.sec.gov/info/smallbus/secg/risk_return_secg.htm#foot1. The prospectus risk/return summary includes information about a fund's investment objectives and strategies, investment risk, performance and fees and expenses. The SEC recently added a mutual fund comparison tool to its website that demonstrates the use of data tagged information extracted from filings made by funds participating in the voluntary program (as discussed in the April 15, 2008 *Alert*).

➤ **FRB and FTC Propose Risk-Based Pricing Notice**

Under a joint proposed rule issued by the FRB and the FTC implementing Section 311 of the Fair and Accurate Credit Transactions Act of 2003, a lender would be required to provide a consumer with a risk-based pricing notice when, based on the consumer's credit report, the lender offers credit to the consumer on terms less favorable than the terms it offers to other consumers. Risk-based pricing refers to the practice of using a consumer's credit report, which reflects his or her risk of nonpayment in setting or adjusting the price and other terms of credit offered or extended to a particular consumer. The proposal would apply, with certain exceptions, to all lenders that engage in risk-based pricing. The proposal calls for a risk-based pricing notice to be provided, generally, to the consumer after the terms of credit have been set, but before the consumer becomes contractually obligated on the credit transaction. The proposal provides a number of different approaches that lenders may use to identify the consumers to whom they must provide risk-based pricing notices. In addition, the proposal includes certain exceptions to the notice requirement. The most significant of the exceptions permits lenders, in lieu of providing a risk-based pricing notice to those consumers who receive less favorable terms, to provide all of their consumers with their credit scores and explanatory information. Comments on the proposal must be received by August 18, 2008.

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Other Item of Note

➤ **U.S. Supreme Court Rejects Challenge to States' Income Tax Exemption for Interest from Their Own Bonds**

In a 7-2 decision, the United States Supreme Court held that the State of Kentucky's practice of providing a state income exemption for interest from bonds it and its political subdivisions issue, while taxing the interest on bonds issued by other states and their political subdivisions, was not a violation of the Commerce Clause of the U.S. Constitution. (*Department of Revenue of Kentucky v. Davis*, No. 06-666 (May 19, 2008).)