

Financial Services Alert

Goodwin Procter LLP, a firm of 700 lawyers, has one of the largest financial services practices in the United States.

New Subscribers, Past Issues and Background

Material: If you would like anyone else to receive issues of the Financial Services Alert, would like to receive any past issues, or would like the background materials for any of the matters discussed in this issue, please contact **Greg Lyons, Eric Fischer, Elizabeth Shea Fries** or **Jackson Galloway** at 617.570.1000 or at the e-mail addresses referenced at the end of this newsletter.

Alert on the Web:

Back issues of the *Alert* are available at www.goodwinprocter.com/Publications/Financial%20services%20Alerts.aspx

In this issue:

Developments of Note

1. FRB Issues Guidance on Retail Sweep Requirements
2. DOL Releases Advisory Opinion that a U.S. Branch of a Non-U.S. Bank is 'Bank or Trust Company' under ERISA
3. OCIE Issues First *ComplianceAlert* to CCOs Outlining Recent Examination Deficiencies and Weaknesses
4. FRB Approves Final Rule Eliminating Certain Regulation O Requirements
5. OCC Permits Custody Trust Ledger Deposit Account Program
6. FinCEN Issues Guidance Regarding Law Enforcement Requests to Financial Institutions that They Allow Accounts to Remain Open Despite Suspicious or Potential Criminal Activity
7. SEC Staff Grants No-Action Relief to Permit REIT to Treat Tier 1 Mezzanine Loans as Qualifying Interests for Purposes of Section 3(c)(5)(C) of the 1940 Act

Other Items of Note

8. Goodwin Procter's Financial Services Practice Group Ranked Nationally in All of its Practice Areas
9. SEC to Act on Voluntary XBRL Tagging of Mutual Fund Risk/Return Summaries and Mandatory Internet Posting of Proxy Materials at June 20 Open Meeting
10. SEC Eliminates Short Sale Price Tests, But Tightens Short Sale Delivery Requirements under Regulation SHO
11. OTS and CSBS Enter Into Consumer Complaint Sharing Agreement

Developments of Note

Ø FRB Issues Guidance on Retail Sweep Requirements

The FRB issued guidance regarding requirements for a retail sweep program to comply with the Board's Regulation D (reserve requirements). Specifically, the retail sweep program involves a transfer of funds between a customer's transaction account and savings account up to 6 times per month via preauthorized or automatic transfers (and thereby such transfers reduce the reserve requirements for the bank).

Account Establishment. The guidance first states that a bank must ensure it has amended its customer account agreement to provide for 2 distinct accounts or legally distinct subaccounts (a transaction and a savings account). If the customer's initial deposit account reserved the right to amend the account with advance notice, then advance notice may be sufficient to establish 2 accounts. Otherwise a separate agreement with the customer will be required.

Recordkeeping. A bank also must reflect the two different types of accounts in its official books and records. If possible, the accounts should be reflected in the general ledger. If the general ledger is not sufficiently disaggregated to make this distinction, then the accounts may be reflected in supplemental bank records. Those supplemental records, however, must meet all the requirements to be deemed official books and records (*e.g.*, be consistent with the Call Reports, and be subject to prudent bank oversight and control).

Disclaimer:

This publication, which may be considered advertising under the ethical rules of certain jurisdictions, is provided with the understanding that it does not constitute the rendering of legal advice or other professional advice by Goodwin Procter LLP or its attorneys.

Movement of Funds. The official books and records must reflect the movement of funds between accounts each day the sweep occurs before the close of business that day. The term “close of business” refers to the time the bank cuts off receipt of work for posting to its general ledger accounts for that day (*i.e.*, the bank cannot post the movement of these funds after the closing of its books for general ledger purposes).

Ø DOL Releases Advisory Opinion that a U.S. Branch of a Non-U.S. Bank is ‘Bank or Trust Company’ under ERISA

The Department of Labor (“DOL”) said in an advisory opinion that a Connecticut branch of the Bank of Ireland would be considered a “bank or trust company” under ERISA Section 408(b)(8) and would be a “bank” for purposes of prohibited transaction exemption 91-38, for transactions involving collective investment funds for employee benefit plans.

The DOL based its opinion on, among other factors, the fact that the Bank’s U.S. branch is subject to significant regulatory oversight and review by the Connecticut Banking Commissioner and the Connecticut Banking Department; that the U.S. branch and the Bank’s other U.S. operations are subject to the jurisdiction of, and extensive oversight and supervision by, the FRB; and that the Bank is subject to the jurisdiction of the state and federal courts in the U.S., and can be sued in those courts.

The opinion stated: “It is the view of the department that a U.S. branch of a non-U.S. bank that has been licensed to engage in banking and trust business by a state regulator, and that is subject to the same level of oversight and regulation as any other comparable banking entity established in that state, would qualify as a ‘bank or trust company’ for purposes of Section 408(b)(8) and PTE 91-38.”

Goodwin Procter obtained this DOL advisory opinion on behalf of a client.

Ø OCIE Issues First **ComplianceAlert** to CCOs Outlining Recent Examination Deficiencies and Weaknesses

The SEC’s Office of Compliance Inspections and Examinations (“OCIE”) released its first *ComplianceAlert* letter designed to inform CCO’s about common deficiencies and weaknesses identified in OCIE’s recent examinations activity. The *ComplianceAlert* addresses the following topics:

- 19a-1 notices for closed-end fund distributions
- adviser advertising (ads and compliance procedures)
- mutual fund “as of” transaction practices
- adviser disaster recovery plans
- broker-dealer sales practices for 529 plans, CMOs and private REITs
- supervisory procedures relating to Reg. SHO
- charges in SMA accounts inconsistent with customer agreements and offering documents
- part-time financial and operations principals
- broker-dealer expense-sharing arrangements

The *ComplianceAlert* will be discussed in greater detail in a future edition of the *Alert*.

Ø FRB Approves Final Rule Eliminating Certain Regulation O Requirements

The FRB approved a final rule (the “Final Rule”) that implements Section 601 of the Financial Services Regulatory Relief Act of 2006 by eliminating certain statutory reporting and disclosure requirements relating to insider lending. Those requirements are included in FRB Regulation O. The Final Rule is substantially unchanged from an interim version of the rule discussed in the December 12, 2006 *Alert*.

The FRB said that it eliminated these Regulation O requirements because they are not particularly useful in monitoring insider lending or preventing insider abuses.

Specifically, the Final Rule eliminates the requirements that: (1) an executive officer of a bank file a report with the bank's Board of Directors when the executive officer obtains certain extensions of credit from another bank; (2) a bank include a separate report with its Call Report on any extensions of credit the bank made to its executive officers during the applicable quarter; and (3) banks report and publicly disclose extensions of credit to an executive officer or principal shareholder of a bank by one of the bank's correspondent banks.

The FRB stressed that the Final Rule does not alter the substantive restrictions in Regulation O on loans made to executive officers and principal shareholders of banks or to insiders of correspondent banks of the lending bank. Moreover, Regulation O continues to require that a depository institution and its insiders maintain sufficient information to enable regulatory examiners to monitor the bank's compliance with Regulation O. The Final Rule will become effective on July 2, 2007.

Ø OCC Permits Custody Trust Ledger Deposit Account Program

In Interpretive Letter 1078 ("Letter 1078") the OCC permitted a bank to engage in a Custody Trust Ledger Deposit Account Program (the "Program") involving the deposit of cash from a broker-dealer ("BD") into the bank's trust department. The Program permits the deposit by BDs of customer funds in accordance with Securities Exchange Act of 1934 Rule 15c3-3. The deposits would be housed and recorded in the trust department's accounting system, and represent a claim against the trust department. The trust department will compensate the BD monthly in the form of a payment of interest based on the balances maintained by the BD. The trust department, in turn, would deposit the funds in a money market deposit account of the bank in the trust department's name, and will receive a non-cash earnings credit as part of the bank's internal allocation.

Letter 1078 held that it is a permissible custody activity in the trust department for the bank to hold and pay interest on these deposits. Moreover, since all transfers in and out by the BD would be by wire, the Program does not violate Section 92a(d) of the National Bank Act, which precludes a trust account from receiving funds subject to check. Letter 1078 also provides that the payment of interest on the trust accounts is consistent with safe and sound banking practices. Letter 1078 notes, however, that it is not ruling whether the funds deposited by the BD should be subject to FRB Regulation D's reserve requirements or Regulation Q's limit on payment of interest on deposits.

Ø FinCEN Issues Guidance Regarding Law Enforcement Requests to Financial Institutions that They Allow Accounts to Remain Open Despite Suspicious or Potential Criminal Activity

FinCEN issued guidance (the "Guidance") to financial institutions ("FIs") regarding requests by law enforcement authorities to FIs that the FI allow an account at the FI to remain open notwithstanding suspicious or potential criminal activity in connection with the account. FinCEN states that FIs should make certain that such law enforcement requests are: (a) in writing; (b) issued by an appropriate law enforcement official; (c) indicate that the FI has requested that the FI maintain the account; and (d) state the purpose of the law enforcement request, *e.g.*, to monitor the account. The maintenance period initially requested should not exceed six months, but law enforcement officials may request additional account maintenance periods that begin after the expiration of the initial period. The Guidance recommends that FIs keep records of such requests for at least 5 years after the request has expired.

FinCEN stresses that "ultimately, the decision to maintain or close an account should be made by an [FI] in accordance with its own standards and guidelines," but notes that complying with such requests may help law enforcement officials to combat money laundering, terrorist financing and other crimes. Finally, the Guidance cautions that an FI must file a suspicious activity report even if the FI is keeping the account open at the request of law enforcement officials.

Ø SEC Staff Grants No-Action Relief to Permit REIT to Treat Tier 1 Mezzanine Loans as Qualifying Interests for Purposes of Section 3(c)(5)(C) of the 1940 Act

The staff of the SEC's Division of Investment Management (the "staff") granted no-action relief to a real estate investment trust (the "REIT") to allow it to treat certain mezzanine loans made specifically and exclusively for the financing of real estate as "qualifying interests" for purposes of complying with the exclusion in Section 3(c)(5)(C) of the Investment Company Act of 1940, as amended (the "1940 Act"), from the definition of investment company. Section 3(c)(5)(C) of the 1940 Act provides this exclusion for an issuer that, in relevant part, is "primarily engaged in . . . purchasing or other acquiring mortgages and other liens on an interest in real estate." The SEC staff has required an issuer relying on this exclusion to have at least 55% of its assets consist of "mortgages and other liens on an interest in real estate" (referred to as "qualifying interests") and the remaining 45% of its assets consist primarily of real estate-type interests. The REIT sought no-action relief to treat the mezzanine loans in question as qualifying interests, even though they are not directly secured by real estate. The REIT argued that except for the lack of a mortgage loan against the property, the mezzanine loans are the functional equivalent of, and provide the holder with the same economic experience as a second mortgage, which would be a qualifying interest, and that the staff had granted no-action relief in the past to allow certain other real estate investments to be treated as qualifying interests on the basis of a "same economic experience" rationale.

The Mezzanine Loan Arrangements. The mezzanine loans in question, referred to as Tier 1 mezzanine loans, involve loans by the REIT as mezzanine lender to a special purpose bankruptcy remote entity (the mezzanine borrower) whose sole purpose is to hold all of the ownership interests of another special purpose entity that owns the commercial real estate being financed and that is subject to a mortgage loan secured by that property. (Tier 1 mezzanine loans are used in lieu of second mortgages.) Under the terms of their respective organizational documents and loan documents, the property-owning entity may not engage in any business other than owning and holding the underlying property, and the mezzanine borrower may not engage in any business other than owning and holding the ownership interests in the property-owning entity. The ownership interests held by the mezzanine borrower have no value apart from the underlying real property held by the property-owning entity other than incidental assets related to ownership of the property, such as cash generated from rental payments and held for short periods of time pending distribution or disbursement for operating expenses. The mezzanine borrower enters into an agreement with the REIT as mezzanine lender under which the mezzanine borrower pledges its entire ownership interest in the property-owning entity as collateral for the mezzanine loan. The aggregate principal balance of a mortgage loan and mezzanine loan at origination is less than the value of the underlying property so that the mezzanine loan is fully secured by the underlying real property. The REIT obtains a first priority perfected security interest in the mezzanine borrower's ownership interests in the property-owning entity so that if the mezzanine borrower were to default on a mezzanine loan, the REIT would have the right to foreclose on the collateral and, through its 100% ownership of the property-owning entity, become the owner of the underlying real estate. Under an intercreditor agreement between the REIT and the mortgage lender, the REIT has rights that allow it to readily cure defaults or purchase the mortgage loan in the event of a default.

Conditions of the No-Action Relief. In concurring with the view that a Tier 1 mezzanine loan may be considered a qualifying interest, the SEC staff pointed in particular to the following representations made by the REIT in its request for no-action relief: (1) a Tier 1 mezzanine loan is a subordinated loan made specifically and exclusively for the financing of real estate; (2) both second mortgages and Tier 1 mezzanine loans are underwritten based on the same considerations and after the lender performs a hands-on analysis of the property being financed; (3) the REIT as Tier 1 mezzanine lender exercises ongoing control rights over the management of the underlying property; (4) the REIT as Tier 1 mezzanine lender has the right to readily cure defaults or purchase the mortgage loan in the event of a default on the mortgage loan; (5) the true measure of the collateral securing the Tier 1 mezzanine loan is the property being financed and any incidental assets related to the ownership of the property; and

Lynne B. Barr
Gary A. Beller
Kay E. Bondehagen
Raymond P. Boulanger
Agnes Bundy Scanlan
Margaret B. Crockett
Eric R. Fischer
Martin J. Flynn
Elizabeth Shea Fries
Jackson B.R. Galloway
Geoffrey R.T. Kenyon
Satish M. Kini
Thomas J. LaFond
Paul W. Lee
Gregory J. Lyons
Robin J. H. Maxwell
William P. Mayer
Philip H. Newman
Sean P. O'Malley
Christopher E. Palmer
Regina M. Pisa
Mark S. Raffman
Victoria E. Schonfeld
William E. Stern
Michael P. Whalen
Meryl E. Wiener

To e-mail any of the above attorneys, use first initial of first name followed by last name followed by @goodwinprocter.com. For example, the e-mail address for Gregory J. Lyons would be glyons@goodwinprocter.com

(6) the REIT as Tier 1 mezzanine lender has the right to foreclose on the collateral and through its ownership of the property-owning entity become the owner of the underlying property.

Other Items of Note

Ø Goodwin Procter's Financial Services Practice Group Ranked Nationally in All of its Practice Areas

The well-respected legal directory *Chambers USA: America's Top Leading Lawyers for Business* this year has named Goodwin Procter's Financial Services Group among the top national law firms in each of its practice areas: asset management, banking and consumer financial services. *Chambers* also highlighted the Group's focus on the integration of these areas for the benefit of clients. Client interviews form the basis for *Chambers'* rankings, and we very much appreciate this recognition. *Chambers* also listed life sciences, private equity and REITs as other areas of national prominence.

Ø SEC to Act on Voluntary XBRL Tagging of Mutual Fund Risk/Return Summaries and Mandatory Internet Posting of Proxy Materials at June 20 Open Meeting

The SEC announced that at its open meeting on Wednesday, June 20, among other things, it intends to consider whether to adopt (a) amendments to expand its interactive data voluntary reporting program to permit mutual funds to submit as exhibits to their registration statements supplemental tagged information contained in their prospectus risk/return summaries (see the February 6, 2007 *Alert* for a discussion of these amendments as proposed) and (b) amendments to its proxy rules under which issuers and other soliciting persons must post their proxy materials on an Internet web site and provide shareholders with a notice of the Internet availability of the materials (see the January 30, 2007 *Alert* for a discussion of these amendments as proposed).

Ø SEC Eliminates Short Sale Price Tests, But Tightens Short Sale Delivery Requirements under Regulation SHO

The SEC voted to adopt rule amendments that repeal the short sale price restrictions (or "tick tests") under Rule 10a-1 under the Securities Exchange Act of 1934, as amended, and prohibit any self regulatory organization (e.g., NASD or Nasdaq) from having a price test. The SEC also voted to adopt rule amendments that tighten close-out requirements for failures to deliver on short sales by eliminating certain grandfathering provisions with respect to securities that become threshold securities (i.e., are put on a list of those hard-to-buy securities that occasion a high number of failures to deliver). However, failures to deliver with respect to Rule 144 securities were granted additional time for close-out. The SEC also voted to propose amendments to the long sale marking requirements of Reg. SHO and repropose amendments addressing other elements of Reg. SHO's failure to deliver provisions. The SEC has not issued formal releases relating to these Reg. SHO amendments, which will be discussed in greater detail in a future edition of the Alert once the releases become publicly available.

Ø OTS and CSBS Enter Into Consumer Complaint Sharing Agreement

The OTS and the Conference of State Banking Supervisors entered into a memorandum of understanding regarding sharing consumer complaint information between the OTS and state banking regulators. The agreement serves as a model for sharing individual consumer complaints for processing by the OTS or the appropriate state banking agency. It also provides for periodic reports of the number of complaints forwarded to the states or the OTS, complaint disposition, and other summary information. Click here <http://www.ots.gov/docs/7/777043.html> for the OTS press release.