

Financial Services Alert

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Developments of Note

➤ **DOL Issues Proposed Regulation on Disclosure Requirements for Participant-Directed ERISA Plans**

The Department of Labor (the "DOL") issued a proposed regulation (the "Proposed Regulation") under Section 404(a) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which sets forth fiduciary requirements for participant-level disclosure in participant-directed individual account plans (*e.g.*, most so-called 401(k) plans). The Proposed Regulation represents the DOL's third recent step in imposing additional fee disclosures on persons providing services to ERISA plans. The first two steps, which included enhanced Form 5500, Schedule C reporting requirements and a proposed regulation under Section 408(b)(2) of ERISA relating to service provider fee disclosures, were discussed in the January 1, 2008 *Alert*. The Proposed Regulation would require plan fiduciaries to disclose certain plan-related information and certain investment-related information to plan participants and beneficiaries.

Plan fiduciaries would have to disclose certain plan-related information to participants and beneficiaries on or before plan eligibility and at least annually thereafter. This information could be included in the plan's summary plan description ("SPD"). In addition, certain specific information would have to be provided to participants and beneficiaries at least quarterly. Plan fiduciaries would also have to disclose any material change to such information. The required plan-related information would include the following:

- general information relating to participant investment instructions, including how participants and beneficiaries may give investment instructions, an explanation of any limitations on such investment instructions, and identification of the plan's designated investment alternatives;
- information relating to plan-level administrative expenses that are not included in investment-related fees and expenses that may be charged against a participant's account, plus a quarterly statement indicating the amount actually charged to the participant's account during the prior quarter; and

- information relating to participant-specific administrative expenses (*e.g.*, loan or QDRO fees), plus a quarterly statement indicating the amount actually charged to the participant's account during the prior quarter.

Plan fiduciaries would also have to disclose certain investment-related information to participants and beneficiaries on or before plan eligibility and at least annually thereafter. This information would have to be provided with respect to each designated investment alternative in a comparative format. The DOL provided a safe harbor comparative chart, a copy of which is available at [DOL Safe Harbor Comparative Chart](#). The required investment-related information for each designated investment alternative would include the following:

- identifying information, including (i) the name of the investment alternative, (ii) a specific internet web site address leading to supplemental information regarding the investment alternative, (iii) the type or category of investment (*e.g.*, large-cap, money-market), and (iv) the type of management of the investment alternative (*e.g.*, active or passive);
- performance data, including (i) average annual total return of the investment alternative for the prior one, five and ten calendar years (to the extent available), (ii) for investment alternatives with a fixed rate of return (*e.g.*, GICs), both the fixed rate of return and the term of the investment, and (iii) comparisons of the returns to an appropriate broad-based index for the prior one, five and ten calendar years (to the extent available); and
- fee and expense information, including (i) the amount and description of each fee charged against a participant's account (*e.g.*, sales loads and redemption fees), (ii) the total annual operating expenses of the investment alternative expressed as a percentage (*e.g.*, the expense ratio), and (iii) a statement indicating that fees and expenses are only one of several factors that participants and beneficiaries should consider when making investment decisions.

Certain additional investment-related information would have to be provided to participants and beneficiaries upon request, including prospectuses and financial statements or reports. The Proposed Regulation would generally permit disclosure of asset-based expenses by describing the relevant rate or formula. The Proposed Regulation would not require disclosure of revenue-sharing payments and would not require a breakdown of expenses on a service-by-service basis. Importantly, the above requirements concerning investment-related information would apply only with respect to the plan's designated investment alternatives, and would not apply to brokerage windows or other investment alternatives that were not designated investment alternatives. Further, the DOL noted that plan fiduciaries would be able to rely in good faith on information provided by service providers.

The DOL also issued a proposed amendment to its regulation under Section 404(c) of ERISA to conform the participant-disclosure requirements under the two regulations.

The Proposed Regulation is proposed to be effective for plan years beginning on or after January 1, 2009. Comments are due by September 8, 2008, and the Proposed Regulation is expected to be finalized by the end of the year.

➤ **Basel Committee, in Conjunction with IOSCO, Publishes Proposals on Capital for Incremental Risk in Trading Book and Value-at-Risk Models**

In furtherance of the recommendations set forth in the Financial Stability Forum's report in April, 2008 (see the April 15, 2008 *Alert*), as well as the perceived significant losses financial institutions have incurred in their trading book, the Basel Committee on Banking Supervision (the "Basel Committee") published a proposal providing guidelines for computing capital for incremental risk in the trading book ("IRC Proposal"), and a proposal with certain changes to the Basel II framework (the "Framework") concerning internal Value at Risk ("VaR") models (the "VaR Proposal"). Both proposals were developed jointly with the International Organization of Securities Commissions and will apply to

investment firms as well as to banking institutions. Comments on both proposals are due by October 15, 2008.

IRC Proposal

Purpose and Scope. The purpose of the IRC Proposal is to address a number of perceived shortcomings in the risks captured in, and associated capital charges for, the current 99%/10-day Value at Risk (“VaR”) framework. In October, 2007, the Basel Committee published for comment guidelines meant to compute capital for incremental *default* risk in the trading book. In light of market events since then, the Basel Committee decided to expand the scope of the capital charge to include not only default risk, but also other sources of price risk, such as significant moves in credit spreads, referred to in the IRC Proposal as the incremental risk charge (“IRC”), as more fully defined below. The IRC would apply only to banks that are subject to the 1996 Market Risk Amendment (“MRA”) and that seek to model specific risk in the trading book. Banks subject to MRA but not modeling specific risk would continue to be subject to the current rules.

Calculation of the IRC. Under the IRC Proposal, the trading book charge would consist of three components: (1) a general market risk charge; (2) a specific risk charge (each of (1) and (2) using the current VaR model); and (3) the IRC. The separate surcharge for specific risk under the current trading book framework would be eliminated.

As to the IRC, it would include all positions subject to the MRA (*e.g.*, debt securities, equities, and securitizations), except for positions whose valuations depended solely on commodity prices, foreign exchange rates, or the term structure of default-free interest rates. IRC covered risks would include default risk, credit migration risk, credit spread risk, and equity price risk. The IRC must capture these risks regardless of whether they are already captured in a bank’s 10-day VaR.

The IRC must incorporate these risks at the 99.9 percent confidence interval over a capital horizon of one year, taking into account the “liquidity horizons” applicable to individual trading positions or sets of positions. The liquidity horizon represents the time required to sell a position or to hedge all material risks in a stressed market, and the IRC Proposal sets floors as to these horizons based on the greater of specified time periods and the bank’s actual experience. For example, the liquidity horizon for equities generally is the greater of one month or the bank’s actual trading experience; for re-securitizations, the floor is one year. A bank would be permitted to assess liquidity on a position or bucketed basis.

Intra- and inter-obligor hedging may be incorporated into an IRC model, subject to specific guidelines set forth in the IRC Proposal. As indicated above, the IRC Proposal currently does not offset for double-counting of risks inside both the current VaR model and the IRC. However, the IRC Proposal does provide for the possibility of a bank developing an approach to address the double counting issue, subject to regulatory approval.

Internal Risk Measurement Modeling. The IRC Proposal does not mandate any specific modeling approach for the IRC, and indeed anticipates that banks will develop different IRC approaches. The bank’s ultimate approach is subject to the “use test” (*i.e.*, it must be used in the bank’s risk management framework). The IRC Proposal states that ideally the principles in the IRC Proposal would be incorporated into internal models for calculating trading book risk, however this is not a requirement. Nonetheless, the bank must be able to demonstrate that its internal approach provides a conservative estimate of capital charges incurred for the risks identified in the IRC Proposal. Banks must calculate the IRC at least weekly.

Validation. The IRC Proposal provides that banks would apply the same validation procedures developed for the Basel II and MRA rules for the IRC. Banks would not be required to use the backtesting regime applied to trading risk VaR models, but quantitative validation should remain important to a bank’s internal validation process.

Phase-in/Disclosure. If a bank already has a specific risk model, in order to retain that model after January 1, 2010 it would have to, by that date, have an approved IRC model incorporating at least default and migration risks, and would have to have an IRC model incorporating all risks by January 1, 2011. The IRC Proposal does provide a “temporary fallback option”, subject to supervisory approval, for those institutions unable to meet the January 1, 2010 deadline.

As to disclosure, the IRC Proposal would require that the IRC be disclosed publicly alongside and at the same frequency as disclosures of a bank’s market risk capital calculation.

VaR Proposal

Purpose and Scope. The purpose of the VaR Proposal is to create an updated framework for internal VaR modeling that is responsive to risks to banks that have been brought to light by recent market events. Banks would be expected to comply with the revised Framework in order to receive approval for using internal models for the calculation of market risk capital requirements.

Proposed Changes to VaR Modeling Methodology. The VaR Proposal would require banks to justify to their supervisors any factors used in pricing which are not included in the calculation of VaR. In addition, under the VaR Proposal the bank’s VaR model would have to capture certain nonlinearities beyond those inherent in options (*e.g.*, mortgage-backed securities, tranching exposures or n-th loss positions), as well as capturing correlation risk and basis risk. Moreover, under the VaR Proposal, the bank’s supervisor would have to be satisfied that proxies were being used that show a good track record for the actual position held. The VaR Proposal also would require a bank that uses VaR numbers calculated according to holding periods shorter than ten days that are scaled up to ten days to periodically justify the reasonableness of its scaling-up method to the satisfaction of its supervisor.

Under the VaR Proposal, banks would also be required to use hypothetical backtesting at least for validation, to update the market data used in the VaR modeling at least monthly and to be in a position to update it in a more timely fashion if deemed necessary. Finally, the VaR Proposal clarifies that it is permissible to use a weighting scheme for historical data that is not fully consistent with the requirement that the “effective” observation period must be at least one year, as long as that method results in a capital charge at least as conservative as that calculated with an effective observation period of at least one year.

Proposed Changes to Prudent Valuation Methodology. To complement the above changes to the VaR methodology, the Basel Committee has made the language with respect to prudent valuation for positions subject to market risk more consistent with existing accounting guidance. The VaR Proposal clarifies that a bank’s supervisors would retain the ability to require adjustments to a bank’s current valuation of a position beyond those required by financial reporting standards where there is uncertainty around the liquidity of that position. Furthermore, the VaR Proposal indicates that actual market prices or observable inputs should be considered for the purposes of valuation even when the market is less liquid than historical market volumes and that any use of mark-to-model valuation must be shown to be prudent.

➤ ICI and IDC Publish White Papers on Proxy Voting by Mutual Funds

The Investment Company Institute (the “ICI”) and the Independent Directors Council (the “IDC”) have published white papers examining mutual fund proxy voting. The ICI’s paper (the “ICI Paper”) explores the proxy voting practices of registered investment companies (“funds”), including an examination of actual proxy voting results, while the IDC paper (the “IDC Paper”) focuses on board oversight of mutual fund proxy voting.

ICI Paper. The ICI Paper, entitled “*Proxy Voting by Registered Investment Companies: Promoting the Interests of Shareholders,*” provides a broad analysis of the proxy voting process for funds, with a particular emphasis on analyzing how a sample of funds actually voted their proxies on certain

categories of proposals. The ICI Paper offers a summary of some of the most common types of management and shareholder proposals for shareholder meetings held during the period from July 1, 2006 to June 30, 2007 by companies represented in the Russell 3000 Index (the “Russell 3000”), which measures the performance of the largest 3,000 U.S. companies. The ICI Paper also examines the sponsorship of shareholder proposals including the extent to which certain individuals and entities sponsor a significant proportion of shareholder proposals.

The ICI Paper’s examination of the proxy voting process for funds addresses, among other things, (i) different mechanisms used to determine how funds vote their proxies, (ii) the various ways in which funds and their advisers manage conflicts of interest in the proxy voting process, and (iii) principles and common themes in the proxy voting guidelines of the 35 largest fund families.

A significant portion of the ICI Paper is devoted to an analysis of how funds actually voted with respect to proposals for companies in the Russell 3000 as disclosed in the funds’ filings on Form N-PX for the year July 1, 2006 to June 30, 2007. This analysis includes a comparison of how funds voted to the voting recommendations of the companies’ boards and the recommendations of two proxy voting services, ISS Governance Services/Risk Metrics and Glass Lewis. The ICI Paper also discusses the services provided by proxy administrators and proxy advisory firms, and reviews academic research regarding whether fund adviser voting of fund proxies has been affected by other relationships between advisers and the issuers whose shares are being voted.

IDC Paper. The IDC Paper, entitled “*Oversight of Fund Proxy Voting*,” is another in a series of reports the IDC has published regarding the various duties of mutual fund boards of directors. As it describes the different arrangements registered funds may use to vote fund proxies, the IDC Paper provides lists of factors that a fund board may wish to consider in assessing a proxy voting policy, and in overseeing adviser proxy voting and potential conflicts of interest on an ongoing basis. The IDC Paper also examines the role of third party proxy voting services, including the range of functions that may be performed by third party services and special considerations relating to board approval of third party proxy voting services, and issues related to board voting of fund proxies. A section of the IDC Paper looks at special proxy voting issues that a fund board may need to examine in connection with the use of subadvisers, a manager-of-manager’s structure, an affiliated fund of funds, securities lending and foreign securities. The IDC Paper concludes with an Appendix that analyzes the techniques that investment advisers have developed to identify and resolve conflicts of interest that may arise when they vote fund proxies.

➤ **IRS Issues Private Ruling to Treat a Regulated Investment Company’s Receipt of Settlement Fund Income as Qualifying Income**

The Internal Revenue Service (the “IRS”) released Private Letter Ruling 200825010 on June 20 in which it ruled that income received by a management investment company registered under the Investment Company Act of 1940, as amended, and segregated into eight separate portfolios (each classified as a regulated investment company or “RIC” under the Internal Revenue Code of 1986, as amended (the “Code”)) from a “qualified settlement fund” as a result of a settlement with its former investment advisor will be treated as qualifying income for purposes of Section 851(b)(2) of the Code. Additionally, the IRS ruled that payments made to shareholders from the qualified settlement fund will not be treated as preferential dividends under Section 562(c) of the Code.

Based on findings regarding material omissions and misrepresentations by the RICs’ former investment advisor and other wrongful acts by both the former investment advisor and its principals related to market timing trading activity in the RICs’ shares, the Securities and Exchange Commission (the “SEC”) imposed an order seeking both the disgorgement of profits and civil penalties. In order to settle the SEC’s claims, the former investment advisor and its principals agreed to pay a sum of money to a “qualified settlement fund.” Pursuant to a distribution plan, the money in the fund will be distributed to shareholders of the RICs as compensation for losses sustained by each during the period in which the market timing trading occurred. The amount of the loss sustained by each shareholder will be

determined by first allocating the amounts held in the qualified settlement fund among the RICs based upon the quarterly percentages of the estimated short term profits earned by market timers with respect to each RIC. Such amount will be further allocated to each day in the quarter, and, finally, to each shareholder in proportion to his holdings in each RIC on that particular day. If the total amount allocated to any shareholder is less than a minimum amount, then such shareholder will not receive any distribution from the qualified settlement fund. Rather, the amount allocated to such shareholder will be re-allocated to other shareholders. Certain amounts that are not distributed to the shareholders (*e.g.*, interest earned on amounts held in the fund and amounts intended for shareholders for which settlement checks were never cashed) will be distributed to the RICs.

The IRS ruled that the payments to the RICs relating to the settlement are qualifying income under Section 851(b)(2) of the Code. In so ruling, the IRS determined that the payments relate to the RICs' business of investing in stock, securities and currencies because the recovery of compensation for losses realized on the sale of portfolio assets in response to frequent requests for redemption by market timers bears a direct relation to the normal course of the RICs' business. Likewise, the recovery of penalties associated with the recovery of such losses is directly related to the RICs' normal course of business. Additionally, the IRS ruled that the payment of the settlement proceeds to the affected shareholders of the RICs does not result in preferential dividends under Section 562(c) of the Code.

Like all other private rulings, this ruling may not be relied upon by taxpayers other than the one to whom it was issued.

➤ **FDIC Board Approves Final Policy Statement on Covered Bonds**

The FDIC's Board of Directors approved a final Covered Bond Policy Statement (the "Policy Statement") designed to facilitate the "prudent and incremental development" of the US Covered Bond (as defined below) market. The FDIC said that, although Covered Bonds are popular and widely used in Europe (more than \$2 trillion of Covered Bonds issued), subject to regulatory supervision, and they are also used elsewhere outside of the US, currently there are no statutory or regulatory prohibitions in the US on the issuance of Covered Bonds by US banks.

Covered Bonds are defined by the FDIC in the Policy Statement as non-deposit, general obligation bonds issued by an FDIC-insured depository institution (an "IDI"). Covered Bonds are secured by a pledge of mortgage loans that (as contrasted to the accounting treatment in asset securitization transactions) remain on the IDI's balance sheet. In addition, Covered Bonds are non-recourse obligations and, as defined in the Policy Statement, must have a term greater than one year and no more than thirty years. Importantly, Covered Bonds are structured to provide assurance to an investor that the investor will receive timely payment of principal and interest even if the issuing IDI fails. Investors in Covered Bonds are protected from a decline in the market value of the underlying collateral because if the loan values fall below certain pre-determined thresholds, the IDI must contribute additional performing assets to the collateral pool underlying the Covered Bonds.

The FDIC stated that the Policy Statement is designed to provide guidance on the treatment of Covered Bonds in the case of an IDI's failure and guidance as to when an investor in Covered Bonds issued by an IDI that has failed will be granted expedited access to the pledged collateral underlying the Covered Bonds.

The Policy Statement only applies to Covered Bond issuances made with the consent of the IDI's primary federal regulator. In addition, the IDI's total Covered Bond obligation (including its obligation in the then current issuance of Covered Bonds) under the Policy Statement may not exceed 4% of the IDI's total liabilities. Moreover, under the Policy Statement, the collateral pool underlying the Covered Bonds must consist of: (1) perfected security interests in performing residential mortgages underwritten in accordance with existing supervisory guidance, or (2) to a limited extent, AAA-rated mortgage-backed securities backed solely by eligible mortgages (the mortgage-backed securities may not equal more than 10% of the collateral for any Covered Bond issuance). The Policy Statement provides

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generally that an investor in a Covered Bond issued by a failed IDI may, after the expiration of a 10 business day period following delivery of written notice to the receiver or conservator, “exercise its contractual rights, including liquidation of properly pledged collateral by commercially reasonable and expeditions methods taking into consideration existing market conditions, provided no involvement of the receiver or conservator is required.”

The Policy Statement became effective on July 28, 2008. On the effective date, both FRB Governor Kevin Warsh and Secretary of the Treasury Henry Paulson heralded Covered Bonds as a creative product innovation, which may be successfully exported from the European markets to the US markets and that illustrates the potential benefits of globally connected financial markets. The Department of the Treasury also issued related guidance concerning best practices for residential Covered Bonds.

➤ **New York Governor Signs Law that Permits Interstate *De Novo* Branching**

Governor David A. Paterson of New York signed into law a bill, supported by the New York State Banking Department, that permits interstate *de novo* branching in New York (the “New Branching Law”). The New Branching Law was enacted through the addition of new Sections 223-B (covering authority for interstate *de novo* banking in New York) and 223-C (applications by an out-of-state bank to establish a *de novo* branch in New York) of the New York Banking Law.

The New Branching Law allows out-of-state banks to branch *de novo* into New York State provided that New York’s banks have the reciprocal legal right (under conditions that are no more restrictive than those imposed by New York law) to branch *de novo* into the state where the out-of-state bank has its principal office. New York State Superintendent of Banks Richard H. Neiman stated that the New Branching Law complements the Regional Interstate Branching Memorandum of Understanding agreed to in April 2008 by the banking regulators of New York, New Jersey and Pennsylvania (see the May 6, 2008 *Alert*). The New Branching Law became effective immediately upon Governor Paterson’s signature on July 22, 2008.