

# Financial Services Alert

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## *Developments of Note*

### ➤ **US Banking Agencies Publish Basel II “Standardized” Risk Capital Proposal for Non-Core Banks**

The FRB and the FDIC published a proposal that would implement changes in the current risk-based capital rules and would be available for all but the largest US banking institutions (so-called “Core Banks”). Core Banks are subject to the most advanced version of Basel II (the “Advanced Approach”). This standardized approach proposal replaces the previously reported “Basel IA” approach first reported in the October 11, 2005 *Alert*, and incorporates some of the capital concepts (*e.g.*, in Items 7, 9 and 10, below) of the Advanced Approach reported in the November 6, 2007 and November 27, 2007 issues of the *Alert*. The OCC and the OTS are expected to formally adopt an identical proposal following the OMB review process, whereupon the proposal will be published as an interagency notice of proposed rulemaking in the *Federal Register*. Comments will be due within 90 days of that publication.

*Background and Overview.* The current risk based capital rules, applicable for the vast majority of US banks, are based on an internationally established framework (“Basel I”) that was developed by the Basel Committee on Banking Supervision (the “Basel Committee”) and endorsed by the G-10 authorities in 1988. Dramatic changes in the marketplace, including new products and services as well as improved risk management techniques, led to the Basel Committee’s adoption in 2004 of Basel II -- a comprehensive revision to the general risk-based capital rules. The international Basel II framework entails three different approaches for determining risk based capital requirements (from simplest to most complex): (1) a standardized approach (similar in many respects to this proposal); (2) a

foundation approach (not adopted in the US); and (3) the Advanced Approach (applicable to Core Banks).

Since 2004, when the Advanced Approach came into focus, concerns have been expressed regarding the potential competitive advantage that Core Banks could obtain on smaller banking institutions. To seek to alleviate this competitive disparity somewhat, in 2005 the agencies issued an advanced notice of proposed rulemaking which presented an alternative (“Basel IA”) to the Advanced Approach. See October 11, 2005 *Alert*. As proposed in final form, Basel IA was subject to extensive comment, including comment from industry participants and representatives urging adoption of the “standardized” and more simplified Basel II approach available to many non-US banking organizations in the other G-10 countries. See December 12, 2006 *Alert*. Among other comments, it was noted that the standardized approach applied to a broader range of asset classes, and would more effectively address competitive concerns without imposing undue burdens on banks choosing to adopt it. The agencies now formally have proposed the standardized approach, rather than Basel IA, as an alternative to the current general risk based rules for banking organizations not adopting the Advanced Approach.

#### *Elements of the Proposed Basel II “Standardized” Approach*

As noted above, the Basel II framework, including the standardized methodology, is intended to make capital requirements more risk-sensitive than the current capital rules. This is accomplished in large measure through modification of the risk weighting of various asset classes. The risk weighting process would yield risk-adjusted asset amounts for general credit risk, unsettled transactions, securitization exposures, and equity exposures. Total risk assets would be the sum of these amounts, plus operational risk. Risk weighted capital ratios are calculated by dividing tier one and total qualifying capital by total risk weighted assets.

US Banks (other than Core Banks) would have the option to utilize the standardized approach or to remain subject to the general capital rules. In either case the tier 1 leverage requirements as well as prompt corrective action capital threshold levels would continue to apply. In addition, banking organizations opting for the standardized approach would continue to be subject to potentially higher capital requirements based on the agencies’ exercise of general supervisory authority.

Set forth below are the principal elements of the proposed approach:

1. *Scope of the Proposed Rule.* Core Banks will not have the option to use the standardized approach, and if a non-Core bank holding company (“BHC”) or any subsidiary of a BHC opts for the this approach, all affiliated depository institutions and the parent company generally must do so as well. The banking agencies retain authority to determine whether the standardized approach is appropriate for an institution. BHCs with total assets of less than \$500 million would be exempt from applying the standardized approach as the parent level, and institutions can opt back into the general capital rules upon notice to the relevant agency.
2. *Calculation of Tier One and Total Qualifying Capital.* The minimum tier 1 and total risk based capital levels remain at 4% and 8% respectively, and the elements of each generally remain the same as under the current rules. Deductions from capital have been modified somewhat, and non-financial equity investments would be subject to a specific risk weighting under the standardized approach. Special treatment is prescribed for BHCs with a regulated, consolidated insurance underwriting subsidiary.
3. *Risk Weight Categories.* The proposal increases the number of risk weight categories from 5 to a total of 16 to allow for greater risk differentiation across risk exposures. Risk weights would range from zero to 1250%.
4. *Use of External Ratings.* The use of external ratings to determine risk weighting would be expanded to exposures to sovereigns, public sector entities, banks, and corporations. In addition, the proposal expands the range of recognized financial collateral and eligible guarantors based on

external ratings (as further discussed below). Specific comment is sought on the use of external ratings, in light of recent market experience raising concerns with the ratings process. The standardized approach also provides for the use of inferred ratings based on ratings of related exposures.

5. *General Credit Exposures.* The proposal identifies the following eight categories of general credit exposures (to which the risk weight categories would apply): (i) sovereign entities; (ii) supranational entities (e.g., Bank for International Settlements, the IMF, and the ECB) and multilateral development banks (“MDBs”); (iii) depository institutions, credit unions and foreign banks; (iv) state and local governments; (v) corporate exposures; (vi) regulatory retail exposures; (vii) residential mortgage exposures; and (viii) presold construction loans and statutory multifamily mortgages.

As a general matter, a bank must risk weight exposures to sovereign entities, state and local governments, and corporate entities based on external or inferred ratings. Supranational entities and MDBs would generally be assigned a zero risk weight. A depository institution would be risk weighted one category less favorable than the sovereign of its incorporation. Regulatory retail exposures – non-mortgage loans of less than \$1 million including credit card, other consumer finance exposures, and small business loans – are generally assigned a risk weight of 75%. Residential first lien and junior mortgages loans are risk weighted based on specified loan-to-value ratios, with risk weights ranging from 20% to 150%.

6. *Off Balance Sheet Items and OTC Derivatives.* As is the case under the current rules, under the proposal off balance sheet exposures would be converted to an on balance sheet credit equivalent amount using a credit conversion factor (“CCF”). CCFs are higher under the standardized rules than under the current rules for certain exposures, however, including short term commitments that are not unconditionally cancellable.
7. *Credit Risk Mitigation for General Exposures.* The proposal recognizes the risk mitigating effects of a broader range of collateral (“financial collateral”) than under the current capital rules. Financial collateral includes cash, gold bullion, certain high rated long- and short-term debt securities, publicly traded debt and equity securities, as well as mutual fund shares quoted daily and conforming residential mortgage exposures. Measurement of the risk mitigating effects would be determined based upon three specified approaches: the simple approach (substituting the risk weight of the collateral for the risk weight of the exposure), the collateral haircut approach (based on value of the exposure, value of the collateral, and a range of supervisory or self determined haircuts), or the simple Value at Risk (“VaR”) approach (based on a VaR model subject to back testing and other requirements). In a similar fashion, the standardized approach recognizes a broader range of third party guarantees and credit derivatives by generally substituting the risk weighting of the guarantee or credit derivative for the underlying exposure.
8. *Unsettled Transactions.* Under the proposal, risk weights would be assigned for unsettled and failed securities, foreign exchange and commodities transactions. Risk weights would be based on the market value of the unsettled transactions and the number of days such a transaction remains unsettled.
9. *Securitization Exposures.* In general, securitization exposures, arising from either traditional or synthetic securitizations, would be risk weighted using the ratings based approach, and if such an approach is not applicable, securitization exposures would be deducted dollar-for-dollar from capital. Under the ratings based approach, a securitization exposure would be risk weighted according to the weights assigned to certain external or inferred ratings, which range from 20% to 350%. The standardized approach also specifies capital requirements related to early amortization provisions.
10. *Equities.* Under the proposal a bank would use a simple risk weight approach for equity exposures generally ranging from 300% to 600%, although equity interests in sovereigns and MDBs as well as certain community development funds and certain other equity interests would qualify for a risk weights ranging from 20% to 100%.

*Operational Risk.* Unlike the current rules the proposal also would impose a separate capital charge for operational risk. Operational risk weighting is determined under the basic indicator approach, whereby the amount of related risk weighted assets equals 15% of the average positive annual gross income computed over the prior 3 years, multiplied by 12.5.

*Supervisory Oversight and Disclosure.* Under the proposal, the agencies will retain authority to evaluate a bank's capital adequacy and compliance with the applicable rules in light of a broad range of supervisory factors. The proposal also includes certain disclosure requirements generally consistent with existing GAAP, SEC disclosure requirements, and regulatory reporting requirements.

### ➤ SEC Proposes to Eliminate Specific Credit Rating Standards in 1940 Act and Advisers Act Rules

The SEC voted to propose amendments to five rules under the Investment Company Act of 1940, as amended (the "1940 Act"), and the Investment Advisers Act of 1940, as amended (the "Advisers Act"), that would eliminate their reliance on specific credit ratings. Buddy Donohue, Director of the Division of Investment Management, described the proposal in a presentation to the Commission prior to its vote. This summary is based on his speech, which is available in its entirety at <http://www.sec.gov/news/speech/2008/spch062508ajd.htm>. A future edition of the *Alert* will discuss the formal proposing release in greater detail.

The affected rules are as follows:

#### 1940 Act

Rule 2a-7 (money market funds),

Rule 3a-7 (investment company definition exception for certain structured finance vehicles)

Rule 5b-3 (repurchase agreement look through for diversification test)

Rule 10f-3 (purchase in underwritten offering in which affiliate is syndicate member)

#### Advisers Act

Rule 206(3)-3T (alternative notice and consent conditions for certain principal transactions)

For Rule 2a-7, Rule 5b-3 and Rule 10f-3, and Rule 206(3)-3T, the proposed amendments would eliminate the current requirements in those rules that certain securities carry specified credit ratings and substitute a determination by the investment company or investment adviser, as applicable, that those securities present minimal credit risks and are sufficiently liquid so that they may be sold at or near their carrying value within a short period of time. For Rule 3a-7 under the 1940 Act, the proposed amendments would (a) eliminate the Rule's credit rating requirements in favor of procedures designed to (i) protect the full and timely payment of outstanding fixed income securities and (ii) require that cash flows from a structured finance vehicle's asset pool be deposited in a segregated account and (b) allow only accredited investors and qualified institutional buyers to participate in offerings by vehicles relying on the rule.

*Rule 2a-7 – Additional Detail.* Mr. Donohue's speech provided additional detail on the four principal aspects of Rule 2a-7 affected by the proposed amendments - (a) credit quality determinations, (b) portfolio liquidity, (c) downgrades and defaults and (d) notice provided to the SEC of certain events. Mr. Donohue stated as follows:

*“[Re: Credit Quality]*

First, we propose to amend Rule 2a-7 to require that money market funds make the determination that each portfolio instrument presents minimal credit risks, and whether the security is a "First Tier Security" or a "Second Tier Security" for purposes of the rule. We believe that money market funds would still be able to use credit quality determinations prepared by outside sources, including NRSRO ratings that they conclude are credible, in making credit risk determinations.

*[Re: Portfolio Liquidity]*

Second, the proposed amendments would require that a money market fund hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions in light of the fund's obligations under section 22(e) of the Investment Company Act and any commitments the fund has made to its shareholders. . . . [T]he proposed amendments would also expressly limit a money market fund's investment in illiquid securities to no more than 10 percent of its total assets and define a Liquid Security as a security that can be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the money market fund.

*[Re: Downgrades and Defaults]*

Third, the proposed amendments would also revise Rule 2a-7's downgrade and default provisions [to provide] . . . that in the event the money market fund's investment adviser becomes aware of any information about a portfolio security or an issuer of a portfolio security that suggests that the security may not continue to present minimal credit risks, the money market fund's board of directors would have to reassess promptly whether the portfolio security continues to present minimal credit risks. This proposed requirement would replace the provisions in the current rule that generally require a money market fund board to promptly reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and take such action as the board determines is in the best interests of the fund and its shareholders.

*[Re: Notice to SEC]*

Finally, the proposed amendments would require that money market funds provide the Commission with prompt notice when an affiliate of the money market fund (or its promoter or principal underwriter) purchases from the fund a security that is no longer an Eligible Security, pursuant to Rule 17a-9 under the Investment Company Act. We believe that the current notice provisions, which are triggered when a security held by a fund defaults, provide us with incomplete information about money market funds holding of distressed securities, particularly those that have engaged in an affiliated transaction with an affiliated person. The additional notice, which would impose little burden on money market funds or their managers, would enhance our oversight of money market funds especially during times of economic stress.”

Comments on the proposal are due by September 5, 2008.

**➤ SEC Proposes New Rules Regarding Indexed Annuities that Modify 1933 Act Exclusion with respect to Annuity Contracts and Create Related Exclusion from 1934 Act Reporting for Certain Annuity Contracts**

On June 25, 2008, the SEC proposed two new rules relating to annuity contracts.

First, the SEC proposed Rule 151A under the Securities Act of 1933 (the “1933 Act”), which would define certain indexed annuities as falling outside the exclusion for registration otherwise provided for annuity contracts under Section 3(a)(8) of the 1933 Act. As the SEC noted in the release proposing the amendments, neither the SEC nor the courts have provided definitive guidance on whether indexed annuity contracts are securities that must be registered. Indexed annuities are annuity contracts that provide benefits tied, in part, to the performance of a securities index, but also include guarantees based on a percentage of purchase payments and often some minimum interest. These contracts historically have not been registered as securities. Proposed Rule 151A would provide that an annuity is outside the exclusion of Section 3(a)(8) if both: (1) amounts payable under the contract are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities; and (2) amounts payable are more likely than not to exceed the amounts guaranteed under the contract. The determination of the second factor would be made by the insurance company at or prior to the issuance

of the contract, and that determination shall be conclusive, provided that: (A) both the methodology and the economic, actuarial and other assumptions used in the determination are reasonable; (B) the computations made by the company in support of the determination are materially accurate; and (C) the determination is made not more than six months prior to the date on which the form of contract is first offered and not more than three years prior to the date on which the particular contract is issued. The proposing release requests comments on a variety of matters, including whether the proposed principles-based approach is appropriate, and whether indexed annuities should be able to use Form N-4 if they are to be registered. The SEC proposes to have the new definition apply prospectively – that is, only to indexed annuities issued on or after the effective date of a final rule.

Second, the SEC is also proposing new Rule 12h-7 under the Securities Exchange Act of 1934 (the “1934 Act”), which would provide an insurance company with an exemption from 1934 Act reporting with respect to certain registered securities issued by the company and regulated as insurance under state law. The exemption is designed to cover annuity contracts that trigger 1934 Act reporting when they are registered under the 1933 Act, including indexed annuities, market value adjustment annuities, and guaranteed living benefit contracts. The exemption would not cover insurance company stock or bonds.

The deadline for comments is September 10, 2008.

### ➤ **Closed-End Funds Receive No-Action Relief for Preferred Stock with Liquidity Features and File Application for Exemptive Relief from 1940 Act Asset Coverage Requirements**

The staff of the SEC (the “Staff”) recently provided no-action relief addressing issues raised by liquidity protected preferred shares (“LPP”), a new type of preferred stock proposed to be issued by closed-end investment companies that would be eligible for purchase by money market funds. Several of the closed-end funds that received the no-action relief also filed an application for exemptive relief that would allow them, as a temporary measure, to apply the 200% asset coverage requirement for preferred stock to debt issued to replace existing auction rate preferred shares (“ARPS”), rather than the 300% asset coverage requirement that would otherwise apply. As discussed in the next article in this issue, the IRS provided guidance regarding the tax treatment of LPP issued to replace existing ARPS. These developments are part of efforts on the part of a closed-end investment company sponsor and the closed-end investment companies it sponsors to address liquidity issues in the market for ARPS.

*Background – ARPS and Auction Market Failure.* Historically, closed-end funds have used ARPS to create a leveraged capital structure designed to increase returns to common stockholders. The Investment Company Act of 1940, as amended (the “1940 Act”), limits the capital structure of closed-end investment companies. In general, a closed-end fund may have one class of preferred stock and one class of debt, with the former subject to 200% asset coverage and the latter 300% asset coverage. Because ARPS are preferred stock, they are subject to the 200% asset coverage requirement. Although ARPS are preferred stock, they are designed to perform similarly to commercial paper through a dutch auction mechanism that resets dividend rates on a periodic basis (seven to 28 days) at the minimum levels necessary to match interested sellers and buyers for a price equivalent to the ARPS liquidation preference plus accrued unpaid dividends. The auction mechanism is also designed to provide holders with periodic liquidity.

In February 2008, turmoil in the credit markets resulted in insufficient buyer participation in ARPS auctions, thereby causing ARPS auctions to fail, as they have since then. Because, as preferred stock, ARPS are perpetual securities (*i.e.*, their liquidation preference is not returned to holders on a specified future date in the same way as a bond’s principal is at maturity), ARPS holders unable to sell through the auction process have been forced to retain their holdings unless willing to sell at a discount. In addition, ARPS auction failures have triggered a requirement in the issuing funds’ charter documents requiring them to pay a higher dividend rate on their ARPS, typically referred to as a maximum applicable rate, which may rise or fall depending on specified reference interest rates. As the auction

market failure has continued, the ongoing liquidity issues faced by ARPS holders and the impact of maximum applicable rates have prompted closed-end funds to pursue a variety of alternatives.

*LPP.* LPP are designed to allow closed-end funds to replace or supplement their ARPS with an instrument that is subject to the 200% asset coverage requirement for equity under the 1940 Act but does not have the liquidity issues affecting ARPS. As described in the no-action relief, LPP would be eligible for purchase by money markets funds and include liquidity protection features. In a manner similar to ARPS, LPP would have a dividend that is reset in a weekly remarketing that entails an auction process in which a remarketing agent matches buyers and sellers at the lowest possible dividend rate.

Unlike ARPS, however, LPP would have liquidity protection features under which an LLP issuer contractually engages a third party liquidity provider to unconditionally fulfill sell orders that did not receive matching purchase orders in a remarketing. The agreement with a liquidity provider would also provide that were the agreement to be terminated or not renewed, or an agreement with a replacement liquidity provider to be entered into, LPP holders would be notified at least two remarketings in advance of the event and given the opportunity to sell their LPP in those remarketings. The liquidity providers engaged in this capacity would have to have received a short-term rating in one of the two highest short-term rating categories from the nationally recognized statistical rating organizations specified in Rule 2a-7 under the 1940 Act. These features are designed to allow the LLP's liquidity protection features to act as a "Guarantee" under Rule 2a-7, which allows a security subject to a Guarantee to be assessed for Rule 2a-7's credit quality requirements based on the Guarantee's credit ratings alone. The ability of LPP holders to sell LPP either at auction or through the liquidity protection features is designed to allow LPP to meet Rule 2a-7's maturity conditions.

If a liquidity provider were required to purchase LPP because of insufficient buyer interest in a remarketing, the liquidity provider would be entitled to additional fees from the issuing fund, which would also be required to pay a higher dividend rate on the LPP. In addition, as a further inducement, a liquidity provider could be given rights to put any of the LPP that it had purchased to a fund's sponsor or to the issuing fund, at a price per share equal to the LPP's liquidation preference. (Having a fund that issues LPP provide this kind of put raises issues regarding the treatment of LPP as equity for tax purposes that are addressed in the next article of this *Alert*.)

*Existing ARPS Alternatives.* To date, closed-end funds have availed themselves of two principal means of replacing existing ARPS leverage. Some closed-end funds have replaced their ARPS with debt financing. This alternative has not necessarily provided a means to replace all of a fund's outstanding ARPS because of limitations imposed by the availability of suitable debt financing, transaction costs, potential tax events and the higher asset coverage required for debt under the 1940 Act. Some municipal bond funds have used tender option bonds ("TOB") to replace outstanding ARPS. (In general terms, a municipal bond fund entering into a TOB deposits municipal securities it holds into a trust; the trust issues securities that (i) pay interest at a rate that resets based on a short-term interest rate benchmark and (ii) include a put that allows the holder to tender the security to a liquidity provider. The fund receives cash consideration from the trust, which it may invest in additional securities, and an interest entitling it to income from the trust's holdings remaining after interest is paid to the trust's other security holders on the basis just described.)

*Application for Exemptive Relief.* Five taxable bond closed-end funds that were among the funds receiving the no-action relief described above also submitted an application for an order from the SEC granting an exemption from Section 18(a)(1)(A) of the 1940 Act, which defines the asset coverage requirement for closed-end fund senior securities. The exemption, if granted, would permit each of the applicant funds to refinance its outstanding ARPS with debt as to which a fund would only need to maintain asset coverage of 200%, instead of the 300% generally required for debt. The requested relief would be for a three year period from the date of a fund's first borrowing in reliance on the relief. The relaxed asset coverage requirements are intended to provide the applicant funds with an immediate means of relief from the negative effects of ARPS illiquidity while potential, longer-term alternatives to

ARPS, such as the LPP, are developed and implemented. The Staff has not issued any formal response to the exemptive application.

### ➤ **IRS Issues Guidance on Treatment of Closed-End Fund Auction Rate Preferred Stock**

The Internal Revenue Service (the “IRS”) issued revised Notice 2008-55 (the “Notice”), which addresses issues raised by measures proposed by closed-end funds to resolve problems created by continuing failures in the periodic auctions for the funds’ auction rate preferred stock (“ARPS”). In the Notice, the IRS provided guidance as to the effect of guarantees and liquidity facilities on the equity character of certain ARPS. The Notice provides that the IRS “will not challenge the equity characterization of auction rate preferred stock . . . as a result of adding a liquidity facility . . . to support the auction rate preferred stock” if certain conditions are met. The guidance is intended to allow the ARPS to be issued with liquidity facilities that will make them eligible investments for money market funds and create secondary market interest that will provide ongoing liquidity to ARPS holders. (The immediately preceding article in this *Alert* provides additional detail regarding the ongoing problems in the ARPS auction market; in addition, the LPP described in that article are ARPS proposed to be issued with liquidity facilities to which the IRS guidance would apply)

*ARPS Holder’s Right to Sell to Liquidity Provider.* The liquidity facilities discussed in the Notice provide that holders of ARPS may have the right to sell the stock to an eligible liquidity provider, at a price equal to the stock’s liquidation preference, plus accrued but unpaid dividends, upon the occurrence of either of two “trigger events” – (1) a failed auction or remarketing, or (2) a failure to renew, replace, or extend an existing liquidity facility then in place with the same liquidity provider or another liquidity provider by a date that occurs at least two auction or remarketing dates before the termination date of the existing liquidity facility then in place. The liquidity provider must be an unrelated party to the issuer of the ARPS, with such determination to be made before taking into account any purchase of such stock by the liquidity provider under the liquidity facility. An issuer of ARPS may pay dividends on such stock only if it duly declares such dividends and it pays such dividends out of legally available funds for payments in respect of stock under applicable state law.

*Liquidity Provider’s Right to Put ARPS to Issuer and its Related Parties.* Where a liquidity provider has a contractual right to require the issuer of ARPS, or a related party to such issuer, to redeem or repurchase stock purchased by the liquidity provider under the liquidity facility, any such contractual rights must be limited by applicable state law restrictions on redemptions of stock that apply to any holder of the ARPS. Additionally, to ensure fairness, the liquidity provider must hold ARPS purchased under a liquidity facility for a minimum continuous holding period of at least six months before any redemption or repurchase of such stock. During this required six-month holding period, the liquidity provider must offer such stock for resale at each periodic auction or remarketing duly held under the terms of the stock to set the dividend rate at a price equal to the par amount of the applicable liquidation preference, plus accrued but unpaid dividends. Moreover, except for any contractual rights provided to the liquidity provider to require the issuer of the ARPS to redeem or repurchase stock purchased by the liquidity provider under the liquidity facility, the liquidity provider and any subsequent holder of such purchased stock otherwise must not have any greater rights with respect to such stock than other holders of the stock under the terms of the liquidity facility, the terms of such stock, or applicable state law.

Where a liquidity provider does not have a contractual right to require the issuer of such stock, or a related party to such issuer, to redeem or repurchase stock purchased by the liquidity provider under the liquidity facility, any redemption of such stock purchased by the liquidity provider or any subsequent holder of such purchased stock must be limited by applicable state law restrictions on redemptions of stock that apply to any holder of the ARPS. The liquidity provider and any subsequent holder of the ARPS must not have any greater redemption rights or other rights against the issuer of such stock or a related party to such issuer with respect to such stock than other holders of such stock under the terms of the liquidity facility, the terms of such stock, or applicable state law.

*Scope and Effectiveness.* Notice 2008-55 is effective on June 13, 2008, and applies only to ARPS that was outstanding on February 12, 2008 (the date on which significant auction failures first occurred) or issued after that date to refinance, directly or indirectly, any ARPS that was outstanding on that date, provided that the total par amount of the liquidation preferences on all such stock issued for refinancing purposes is no greater than the total par amount of the liquidation preferences on such outstanding refinanced stock. (Notice 2008-55 was originally issued on June 13, and included a condition that liquidity providers must hold ARPS purchased under a liquidity facility for at least one year before selling it to an issuer or to a related party, rather than the six months provided for in the Notice.)

### ➤ **Basel Committee Issues Proposal on Management of Liquidity Risk**

The Basel Committee on Banking Supervision (the “Basel Committee”) issued a draft paper entitled “Principles for Sound Liquidity Risk Management and Supervision” (the “Principles”). Drawn on recent and ongoing work on liquidity risk conducted by the public and private sectors, the Principles provide guidance intended to strengthen banks’ liquidity risk management and improve global supervisory practices. The Principles, which focus on liquidity risk management at large- and medium-sized banks, follow a February 2008 report from the Basel Committee which stated that many banks had failed to establish an adequate framework to manage liquidity risk when liquidity was more plentiful, noting that banks did not satisfactorily account for the liquidity risks posed by individual products and business lines.

The Principles, which expand on the Basel Committee’s 2000 “Sound Practices for Managing Liquidity in Banking Organisations,” set forth seventeen principles for managing and supervising liquidity risk. In particular, the Principles provide detailed guidance about (1) the importance of establishing a liquidity risk tolerance; (2) the maintenance of adequate liquidity, including through a cushion of liquid assets; (3) the necessity of allocating liquidity costs, benefits and risks to all significant business activities; (4) the identification and measurement of the full range of liquidity risks, including contingent liquidity risks; (5) the design and use of severe stress test scenarios; (6) the need for a robust and operational contingency plan; (7) the management of intraday liquidity risk and collateral; and (8) public disclosure in promoting market discipline.

The Principles also provide additional guidance for supervisors that stresses the importance of supervisors in assessing the adequacy of a bank’s liquidity risk management framework and its level of liquidity. The supervisory guidance sections of the Principles suggest remedial measures for supervisors to take when a bank is not sufficiently managing its liquidity risks, such as improving internal policies and controls, improving contingency planning, or requiring the bank to maintain a higher level of capital. Public comments on the Principles may be submitted through June 29, 2008. This proposal was recommended by a Financial Stability Forum report, which was described in the April 15, 2008 *Alert*.

## *Other Items of Note*

### ➤ **FDIC and U.K.’s Financial Services Authority Agree to Share Information, Cooperate and Consult on Cross-Border Banking**

The FDIC and the United Kingdom’s Financial Services Authority (“FSA”) signed a memorandum of understanding (“MOU”) in which they agreed to share information and plan for contingencies related to cross-border banking activities in the U.S. and U.K. The FDIC and FSA said that they intend to strengthen their consultation and cooperation that is designed to assist them in their analyses of the complexities of cross-border banking operations.

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➤ **OCC Issues Updated Summary of Permissible Activities for National Banks**

The OCC issued an updated booklet concerning national banks' permissible activities. The booklet, entitled *Activities Permissible for National Banks – 2007*, provides updated summaries concerning traditional banking activities and also Bank Secrecy Act/Anti-Money Laundering compliance, consumer compliance, fiduciary activities, insurance and annuity activities, securities activities, technology and electronic banking activities, community development and other investment and preemption issues.

➤ **Senate Confirms Three New SEC Commissioners and New Governor of FRB**

The Senate confirmed Elisse B. Walter and Luis A. Aguilar as the two new Democratic SEC Commissioners, Troy Paredes as the new Republican SEC Commissioner and Elizabeth Duke as a new member of the Board of Governors of the Federal Reserve System. Following the addition of Ms. Walter and Messrs. Aguilar and Paredes (and the departure of current Commissioner Paul Atkins), the SEC will be operating with a full complement of Commissioners. Senate action is still pending on two nominees for openings on the FRB.

- Ms. Walter is currently Senior Executive Vice President, Regulatory Policy & Programs, at FINRA. Prior to joining the NASD (FINRA's predecessor), Ms. Walters served as general counsel of the CFTC. From 1977 to 1994, Ms. Walter was on the SEC staff, eventually serving as Deputy Director of the Division of Corporation Finance.
- Mr. Aguilar is a partner at an Atlanta law firm where he practices corporate and business law. His previous experience includes serving as the general counsel of INVESCO, a global investment advisory organization.
- Mr. Paredes is a professor at Washington University School of Law where his scholarship and teaching focus on corporations, securities regulation, corporate governance and corporate finance.
- Ms. Duke, a former Chairman of the American Bankers Association, currently serves as Senior Executive Vice President and Chief Operating Officer of TowneBank. She previously served as Executive Vice President of the Merger Project Office at Wachovia Bank.