

# Financial Services Alert

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## *Developments of Note*

### ➤ **Indian Authorities Propose to Modify Market Access Rules**

The Securities and Exchange Board of India (“SEBI”) issued proposals to significantly restrict the ability of Foreign Institutional Investors (“FIIs”) to write market access products (TRS, ZSW, etc.) with underlying Indian securities, know as Participatory Notes (“P-Notes”) or Offshore Derivative Instruments (“ODIs”) in the market.

Briefly, SEBI has proposed (i) that all P-Note issuances by sub accounts (as opposed to FIIs) must halt as of the effective date of the proposed new regulations and existing positions should be wound down over a period of 18 months; (ii) FIIs with P-Notes hedged with market traded derivative products, as opposed to cash position, must cease writing such products and wind up these positions over the next 18 months; (iii) FIIs that have P-Notes outstanding with a notional value in excess of 40% of their assets under custody in India may write new market access products only upon redemption/cancellation/expiration of outstanding contracts; (iv) FIIs with P-Notes outstanding with a notional value of less than 40% of their assets under custody in India may only write additional products up to an additional 5% of their assets under custody in India.

Comments were required to be provided to the SEBI by October 20 and the SEBI Chairman held a conference with the broker and investor community on October 22 in Mumbai. The Chairman indicated that the proposals are likely to come into effect largely as drafted after the SEBI board meeting on October 25. More details will be provided separately in Hedge Fund and other Alerts.

### ➤ **Basel Committee Publishes Consultative Document on Incremental Default Risk in the Trading Book**

The Basel Committee on Banking Supervision (the “Basel Committee”), along with International Organization of Securities Commissions, in July 2005 published a paper entitled “The Application of Basel II to Trading Activities and the Treatment of Double Default Effects” (see the July 26, 2005 *Alert*, the “Trading Activities Paper”). The Trading Activities Paper specified that banks must model specific risk to measure and hold capital against any default risk that is incremental to any default risk

captured in the bank's Value-at-Risk ("VaR") model (the "Incremental Default Risk"). The Trading Activities Paper added this requirement to reflect the increasing amount of exposure in the bank's trading book to credit risk and illiquid products.

The Basel Committee has now published a Consultative Document to provide further detail on how banks should fulfill this requirement. The Consultative Paper generally defines the Incremental Default Risk as the greater of zero or (1) the level of capital required to absorb capital that might occur to trading positions due to credit-related defaults, minus (2) any capital requirement for default losses implicit in the VaR. The Incremental Default Risk is designed to cover both direct losses due to an obligor's default, as well as indirect losses from structured instruments such as asset backed securities (but generally would not apply to listed equities, interests in unleveraged funds, and other interests that do not typically have credit risk).

In developing an Incremental Default Risk model, banks must meet a soundness standard comparable to that in the internal-ratings based approach (*i.e.*, 99.9% confidence level over a 1 year horizon). The capital charge for Incremental Default Risk will be based on an assumption of a constant level of risk over that horizon, incorporating the effects of rebalancing as appropriate. In developing the model banks also should take into account liquidity (*i.e.*, the possibility of trading a deteriorating instrument before a default event occurs), with non-investment grade positions and positions of concentration generally implying less liquidity than others. Recognizing the effects of hedging also is permitted.

Banks are expected to validate their Incremental Default Risk model, although backtesting will not be required as it is with the standard VaR. The Consultative Document provides factors to consider in the validation process, with many elements involving validation of probability of default, and loss given default. The Consultative Document states that no specific method of computing Incremental Default Risk is prescribed, and indeed "it is anticipated that banks will develop different approaches for measuring this risk," however the approach that the bank uses is subject to the "use test" (see the October 10, 2006 *Alert*).

Banks are expected to calculate Incremental Default Risk with the same frequency that they calculate market risk. Comments on the Consultative Paper are due to the Basel Committee by February 15, 2008. Banks that already have received specific risk model recognition under the market risk rules are expected to implement this requirement by January, 2010.

### ➤ **FDIC Proposes Amendments to its Annual Audit and Reporting Rules under Part 363**

The Board of Directors of the FDIC approved the issuance of a notice of proposed rulemaking (the "NPR") that would amend FDIC-insured financial institutions' ("FIs") annual audit and reporting requirements under section 36 ("Section 36") of the Federal Deposit Insurance Act and its implementing regulations, Part 363 ("Part 363"). In general, the proposed amendments in the NPR are designed to incorporate into Part 363 certain audit, reporting and audit committee practices derived from the Sarbanes-Oxley Act of 2002 as well as FDIC experience in administering Part 363. The FDIC stated that Section 36 and Part 363 are "generally intended to facilitate early identification of problems in financial management" at FIs with total assets greater than certain thresholds. The asset threshold for internal control assessments is \$1 billion, and the threshold for the other requirements of Part 363 is \$500 million.

In addition to making certain technical amendments to the enforcement rules and procedures used against accountants and accounting firms, the FDIC cites 12 significant changes made by the NPR to Part 363. The 12 key changes would:

1. Require management of the FI and its independent public accountant to identify the internal control framework used to evaluate internal control over financial reporting and disclose all identified material weaknesses;

2. Extend the time period for a non-public FI to file its Part 363 Annual Report by 30 days and replace the 30-day extensions of the filing deadline that may be granted if an FI (public or non-public) is confronted with extraordinary circumstances beyond its reasonable control with a late filing notification requirement that would have general applicability;
3. Provide relief from the annual reporting requirements for FIs that are merged out of existence before the filing deadline;
4. Provide relief from reporting on internal control over financial reporting for businesses acquired during the fiscal year;
5. Require management's assessment of compliance with designated safety and soundness laws and regulations to state management's conclusion regarding compliance and disclose (with more specificity than is currently required) any noncompliance with such laws and regulations;
6. Clarify the independence standards with which independent public accountants must comply and enhance the enforceability of compliance with these standards;
7. Specify that the duties of the audit committee include the appointment, compensation and oversight of the independent public accountant;
8. Require audit committees to ensure that audit engagement letters do not contain unsafe and unsound limitation of liability provisions and require FIs to file copies of these letters;
9. Require certain communications by independent public accountants to audit committees and establish retention requirements for audit working papers;
10. Require boards of directors to adopt written criteria for evaluating an audit committee member's independence and provide expanded guidance for boards of directors to use in determining independence;
11. Require the total assets of a holding company's insured depository institution subsidiaries to comprise 75 percent or more of the holding company's consolidated total assets in order for an FI to comply with Part 363 at the holding company level; and
12. Provide illustrative management reports to assist FIs in complying with the annual reporting requirements.

Comments regarding the NPR will be due to the FDIC no later than 90 days after its publication in the *Federal Register*.

### ➤ Director of SEC Division of Investment Management Discusses Operation Risk and Division Initiatives

At the Investment Company Institute 2007 Operations and Technology Conference, Andrew J. Donohue, Director of the SEC's Division of Investment Management (the "Division"), discussed operation risk in the financial services industry and specific areas of concern for the mutual fund industry. He also reviewed regulatory initiatives currently underway at the Division.

*Operation Risk.* Mr. Donohue observed that the financial services industry is susceptible to situations in which, as a result of complex and highly interconnected systems, a small error, such as wrongly entered digits of a code, can be magnified into a significant negative impact. He cited examples where firms failed to send prospectuses to large numbers of customers as a result of a missed coding change, and instances where firms failed to take necessary corporate actions as a result of clerical errors, such as

improperly entered account numbers. He noted that each of these small errors cost firms tens of millions of dollars in restoring customer accounts and in regulatory fines. Mr. Donohue went on to note that a common risk management approach among the firms has been to develop a complicated algorithms designed to guide their systems and procedures. In developing these algorithms firms have taken into account the details of past negative events and have accounted for circumstances that ultimately led to their occurrence. He observed, however, that using an historical approach may have been appropriate in the past when risks were narrowly defined and generally known, but that now, operational contingencies may not always be susceptible to categorization, and that losses can result from a complicated mix of events, making it hard to predict or model contingencies. As a measure of where he sees the industry standing in terms of addressing operational risk, he pointed to the major financial crises in the last few decades (aside from September 11), which he noted had generally not been triggered by events that would ordinarily be expected to have caused such major disruptions, such as economic downturns or natural disasters. He cited as specific examples the market decline on October 19, 1987, the crisis created by Long Term Capital Management and the effect of the sub-prime crisis on U.S. and world markets.

*Complex Investments.* Turning to specific concerns regarding operation risk in the mutual fund industry, Mr. Donohue focused on the “growth mismatches” that he sees in fund firms’ increasing investment in highly complex investment products, such as over-the-counter derivatives, where the level of sophistication at a firm in terms of back-office support to perform important functions for these instruments, such as documentation, settlement, valuation and confirmation, may not match the level of sophistication of the firm’s portfolio managers and traders who purchase and sell the instruments. He noted that escalating trading volume in complex derivative instruments has put tremendous constraints on, and exposed weaknesses in, firms’ systems for clearing complex products, and that the Division has heard reports of huge backlogs in periods of particularly heavy trading – in one case, confirmations had fallen as much as one week behind. Mr. Donohue observed that some firms, lacking sufficient staff to deal with complex investments, have addressed this problem by outsourcing settlement and confirmation functions to third parties, such as custodian banks or fund administrators. He expressed concern that contracting critical functions to third parties creates gaps in operational processes that could hamper coordination between the functions retained by a firm and those that are outsourced. He cautioned that the controls that firms using outsourcing put into place must take into account the relationships among the parties to make them effective, *e.g.*, by ensuring that when a computer program in one area is updated, all affected functions are made aware of the change.

*Regulatory Developments.* Mr. Donohue discussed current initiatives in the Division in five areas: Rule 12b-1 under the Investment Company Act of 1940, as amended; disclosure reform and interactive data; soft dollars; exchange-traded funds (“ETFs”); and recordkeeping, as follows:

Rule 12b-1. The Division is currently preparing a recommendation to the Commission regarding the Rule based on input from the SEC Roundtable held in June of this year and public comment. Mr. Donohue cited the following suggested regulatory approaches from the Roundtable: (a) revising the factors that fund directors must consider in their annual approval of Rule 12b-1 plans to make them better conform to the manner in which Rule 12b-1 fees are currently used, (b) requiring funds to disclose in shareholder account statements the actual amount of distribution-related expenses that a shareholder paid, and (c) treating Rule 12b-1 fees as account-based fees, assessed directly on individual fund investors, rather than as asset-based fees assessed at the fund level.

Disclosure Reform and Interactive Data. The Division is formulating a recommendation under which funds would be able to offer securities using streamlined disclosures provided directly to investors, with more detailed information available in the forms currently used (*i.e.*, prospectuses and statements of additional information) available on the Internet or in paper upon request. He suggested that information included in the streamlined disclosure document could include investment objectives and strategies, costs, risks and historical returns. Mr. Donohue reviewed briefly the SEC’s ongoing initiative to enhance its disclosure regime through technological

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infrastructure in the form of data tagging of information in filings to permit easier retrieval and analysis of that information through automated means. He noted that the SEC had adopted rule amendments expanding the current interactive data voluntary reporting program to enable mutual funds to submit exhibits to their registration statements containing tagged risk/return summary information. He expressed hope that there would be broad voluntary participation in this program that would allow the SEC to test the interactive tagging systems' usefulness to investors, third party analysts, funds and the marketplace.

**Soft Dollars.** The Division staff is currently working on a recommendation to the Commission that would provide guidance designed to assist mutual fund boards in their oversight responsibilities.

**ETFs.** The Division intends to recommend that the Commission propose a rule to codify the exemptive relief ATFs require to operate, thus eliminating the need to obtain specific relief before beginning operations.

**Recordkeeping.** The Division is actively exploring, among other issues, *how* to reconcile the recordkeeping rules under the Investment Advisers Act of 1940, as amended, and the Investment Company Act of 1940, as amended, with the desire for electronic record retention, including the extent of obligations to retain electronic communications such as e-mails and text messages.

## ***Other Items of Note***

### **➤ Additional Relief Provided by IRS under Section 409A**

In an expansion of the limited transition relief discussed in the September 11, 2007 *Alert*, the Treasury Department and the Internal Revenue Service issued Notice 2007-86 which provides additional transition relief under Section 409A of the Internal Revenue Code of 1986, as amended ("Section 409A"). Section 409A is the tax provision applicable to non-qualified deferred compensation arrangements, including deferred compensation plans, SERPs and certain severance and bonus arrangements. Specifically, the Notice provides a comprehensive extension to December 31, 2008 to adopt amendments to deferred compensation arrangements that are subject to Section 409A. It is important to note, however, that all deferred compensation arrangements that are subject to Section 409A will continue to be subject to good faith compliance with Section 409A through this additional transition period.

### **➤ Comptroller Dugan Discusses Timing on US Basel Initiatives**

Comptroller Dugan gave a speech today whereby he stated that "forward progress" was occurring on US Basel II. Comptroller Dugan further said that "the final rule will become publicly available in early November." As to the alternative approach for non-core banks, the Comptroller stated that the agencies "expect this proposed standardized option to be published in the next several months with the final rule issued before the advanced approaches become operational for the first year of the transition period."