

Financial Services Alert

Goodwin Procter LLP, a firm of 850 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 <http://www.goodwinprocter.com/Publications/FinancialServicesAlerts/Archive.aspx>

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.

©2008 Goodwin Procter LLP
All rights reserved.

In this issue:

Developments of Note

1. SEC Votes to Propose Exemptive Rules Relating to ETFs and to Amend Privacy Rules
2. SEC Issues Exemptive Orders to Permit Actively Managed ETFs
3. SEC Announces 2008 CCO Outreach Regional Seminars for Adviser and Fund Chief Compliance Officers
4. Standard & Poor's Introduces New Capital Benchmark
5. Basel Committee on Banking Supervision Publishes Summary of Report of Liquidity Working Group
6. OCC Issues Interpretive Letter Stating National Bank Shareholders are Authorized to Retain Non-Controlling Interest in Holding Company of National Bank

Other Items of Note

7. GAO Issues Report on Hedge Funds
8. FRB Proposes Changes to Its Payment Systems Risk Policy
9. FDIC Issues Guide on Deposit Insurance Coverage for Revocable and Irrevocable Trusts
10. SEC Issues Release Proposing Amendments to Form ADV Part II and Electronic Filing Requirement

Developments of Note

➤ **SEC Votes to Propose Exemptive Rules Relating to ETFs and to Amend Privacy Rules**

At its open meeting today the SEC voted to propose (a) exemptive rules under the Investment Company Act of 1940, as amended, that would allow exchange traded funds ("ETFs") to operate without first obtaining individual exemptive orders from the SEC, and (b) additional provisions under Regulation S-P that would (i) specify more detailed information security standards, (ii) update the Regulation's safeguarding and disposal provisions and (iii) create a new exception to permit the disclosure of limited personal information when representatives move from one broker-dealer or registered investment adviser to another. This article summarizes information provided in SEC press releases announcing these developments. More extensive coverage will appear in the *Alert* once the SEC issues formal proposing releases.

ETF Exemptive Rules. The SEC's ETF proposal would codify exemptions previously granted by the SEC to index based ETFs and, in several recently issued exemptive orders, to certain actively managed ETFs (see the next story in this issue which discusses those exemptive orders). The proposal would also allow investment companies to make larger investments in ETFs than would otherwise be permitted under 1940 Act's limitations on investments by other investment companies in registered funds. The SEC's ETF proposal also includes amendments to Form N-1A, the registration form for open-end management investment companies, that are designed to facilitate the use of the Form by ETFs to provide information to secondary market purchasers of their shares.

Privacy Rule Amendments. The proposed amendments would provide more specific requirements for safeguarding information and responding to information security breaches, and update Regulation S-P's safeguarding and disposal provisions. In addition, they would extend the application of the disposal provisions to individuals associated with brokers, dealers, SEC-registered investment advisers and SEC-registered transfer agents, and would extend the application of the Regulation's safeguarding provisions to SEC-registered transfer agents. The proposed amendments would also permit a limited transfer of customer information without the notice and opt out required by Regulation S-P when personnel move from one broker-dealer or registered investment adviser to another.

The comment period for each proposal will end 60 days from the date of the proposal's publication in the *Federal Register*.

➤ SEC Issues Exemptive Orders to Permit Actively Managed ETFs

The SEC issued exemptive orders that will allow the offering of actively managed exchange traded funds ("ETFs"). The actively managed ETFs that received exemptive relief include funds that will invest in non-U.S. money market instruments, funds that invest in U.S. equity securities using quantitative screening techniques and a short-term U.S. debt fund. ETFs are investment companies that are typically registered under the Investment Company Act of 1940, as amended (the "1940 Act"), as open-end funds. Unlike typical open-end funds, ETFs do not sell or redeem their individual shares at net asset value ("NAV"). Instead, they sell and redeem shares at NAV only in large blocks (such as 50,000 shares) typically referred to as "Creation Units." National securities exchanges list ETF shares for trading, which creates a secondary market where ETF shares can trade at negotiated prices in non-Creation Unit quantities throughout the day. Because their operations do not conform to the limitations for any of the types of registered collective investment vehicles permitted under the federal securities laws, ETFs must obtain exemptive relief from certain provisions of the 1940 Act before they can conduct a public offering.

The SEC has historically granted the necessary exemptive relief only to index based ETFs, which seek to track the performance of a specified domestic or foreign market index. Because securities selection for an actively managed ETF is based on the ETF's investment objectives and policies rather than the composition of an index, the SEC had expressed concerns that the arbitrage mechanism relied on to control discrepancies between an ETF's market price and its NAV would be less effective for actively managed ETFs. The conditions of the exemptive relief granted to actively managed ETFs generally track those for index based ETFs including the requirement that (a) before trading each day, the actively managed ETF's adviser or sponsor publicly disclose the ETF's portfolio, which will be the basis for its NAV at day's end, and (b) the listing exchange make available an estimate of the ETF's NAV at 15 second intervals throughout the day. Two of the orders also provide for relief from (1) the 1940 Act limits on the ability of other registered funds to acquire shares of the actively managed ETFs and (2) the 1940 Act's affiliated transaction limitations that would prohibit certain affiliates of an actively managed ETF from engaging in in-kind Creation Unit transactions with the actively managed ETF.

➤ SEC Announces 2008 CCO Outreach Regional Seminars for Adviser and Fund Chief Compliance Officers

The SEC announced the schedule and beginning of registration for 25 CCO Outreach regional seminars for registered fund and investment adviser chief compliance officers to be hosted by the various regional offices of the SEC. The seminars will focus on the compliance deficiencies most frequently identified in examinations conducted during the past year, including deficiencies in the following strategic risk areas:

- Advisers Act and 1940 Act Compliance Rules
- Information Processing and Protection
- Performance Advertising and Marketing

- Personal Trading
- Brokerage Arrangements and Execution;
- Information Disclosures, Reporting and Filings
- Portfolio Management

SEC examiners will discuss deficiencies in these areas, how examiners identify them, and corrective action taken by funds and advisers in response. Some seminars will include a supplemental session focused on smaller and newly-registered investment advisers.

➤ **Standard & Poor's Introduces New Capital Benchmark**

Standard & Poor's ("S&P") introduced a new capital benchmark, the Basel II Adjusted Ratio ("BAR"), which will be used in the firm's public credit ratings. The BAR is meant to complement the Basel II regulatory ratios and to add an extra perspective on the adequacy of bank capital as foreign and large U.S. banks transition from the 1988 Basel I standards to the Basel II Capital Accord, which S&P says is likely to take several years. While acknowledging that Basel II has many advantages over Basel I, S&P highlights inconsistency related to banks' choices between the so-called standard approach methodology and the internal ratings-based approach as one of its main concerns with Basel II.

S&P discusses the BAR in detail in a report (the "Report") entitled "Transition to Basel II Creates a Need for a Consistent, Comparable Measure of Bank Capital." In the Report, S&P states that Basel II's greater alignment with economic reality "will reduce banks' ability and willingness to window-dress their published regulatory ratios." S&P also notes that many of the risk measurement systems of Basel II were developed during a more settled economic environment, and that Basel II's calculations may be put to the test during this time of relatively unfavorable economic conditions.

In the Report, S&P describes the BAR as "a refinement of our existing approach that takes into account Basel II and adjusts for its resulting inconsistencies." The goal of the benchmark is to neutralize the impact of Basel II options, national discretions, and differences in banks' internal assessments. S&P stated that it did not expect ratings to change as a result.

S&P will ask for comments on the proposed BAR over the next two months. It will make banks' actual ratios public as soon as banks that have adopted Basel II publish market data required under the new accord. Federal banking regulations implementing the U.S. version of Basel II are scheduled to take effect on April 1, 2008.

➤ **Basel Committee on Banking Supervision Publishes Summary of Report of Liquidity Working Group**

The Basel Committee on Banking Supervision (the "Basel Committee") published a summary (the "Summary") of its Working Group on Liquidity's ("WGL") principal findings regarding liquidity risk management and national supervisory regimes in light of the current liquidity constrained environment. The Summary presents information on the nature of the challenge of liquidity risk management, features of national liquidity regimes, lessons learned from the current liquidity market and outlines areas for future focus of regulatory supervision of liquidity.

The Summary explains that liquidity risk management has become more challenging, even under benign economic conditions, due to a combination of factors: banks increasingly obtaining funding from potentially volatile capital markets; increased use of securitization and the resulting exposure to financial markets and potential contingent liquidity risk; increased use of financial instruments with complicated liquidity characteristics and short track records; increased use of collateral resulting in increased funding liquidity risk; improvements in payment and settlement systems giving rise to new intra-day liquidity risks; and the increased integration and dependence on international markets and cross-border flows by many financial institutions.

The Summary also provides an overview of national liquidity regimes developed by national banking supervisors and notes that, while the high level objectives of such regimes are generally similar, there is diversity amongst the regimes in terms of approaches to supervision and specific rules and guidelines on liquidity. For example, in the area of stress testing and scenario analysis, some regimes prescribe the types of shocks that should be analyzed, while others leave it to the institutions to decide what to test. The diversity in regimes exist for a variety of reasons, including national policy choices that are outside the scope of the bank supervisory regime, such as insolvency regimes, deposit insurance and central bank policies. The diversity in regimes has implications for competition, supervisory coordination and supervisory reporting/communication by institutions and supervisors operating within a diversity of national liquidity regimes.

The Summary highlights several lessons for liquidity risk management that have arisen from current market conditions. Among the lessons is that stress testing needs to be more rigorous and comprehensive as most stress testing did not test for the type of market-wide and multiple market/currency stress currently being experienced by the financial system. The current conditions also have demonstrated a need to strengthen contingency funding plans and assumptions about sources of funding as well as to have a diverse set of elements in a contingency plan. Reputational risk has also emerged as a liquidity concern as banks have provided support to special purpose vehicles for reputational reasons even when not contractually required to do so. It has also become clear from recent events that liquidity risk management is an important goal, because well capitalized banks can have severe liquidity problems.

The Summary states that the Basel Committee and the WGL will continue to work on strengthening liquidity risk management and supervisory practices. The WGL will be updating the Basel Committee's February 2000 Sound Practices for Managing Liquidity in Banking Organizations in light of recent market developments. It is expected that the updates will focus on identifying and measuring liquidity risks, stress testing, the role of supervisors in strengthening liquidity risk management, the management of intra-day liquidity risks associated with payments and settlement and foreign currency liquidity risk from cross-border flows.

➤ **OCC Issues Interpretive Letter Stating National Bank Shareholders are Authorized to Retain Non-Controlling Interest in Holding Company of National Bank**

The OCC issued an interpretive letter ("Letter #1092") in which it concluded that national banks that are existing shareholders (the "NB Shareholders") of a holding company ("HC") that owns a bank (the "Bank") organized under a limited purpose Georgia commercial bank charter may retain their non-controlling interests in the Bank after it converts (the "Conversion") from its Georgia charter to a national bank charter because the non-controlling investment in the national bank meets the standards for non-controlling investments by national banks set forth in 12 C.F.R. § 5.36. None of the NB Shareholders owns 5% or more of the HC stock. The Bank has limited its activities under its Articles of Incorporation to providing banking services to depository financial institutions. The Bank also makes certain direct commercial loans (through a subsidiary) to nonbank borrowers, and the making of such direct loans is permissible under the Bank's Georgia charter. After the Conversion, under its national bank charter, the Bank intends to engage in the same activities that it engaged in under its Georgia charter, including making some direct commercial loans to certain large borrowers whose needs cannot be met by community banks. The Bank will not accept deposits. Letter #1092 states that, after the Conversion, these direct commercial loans will not constitute a significant percentage of the Bank's loan portfolio. The OCC concludes in Letter #1092 that the NB Shareholders, in accordance with 12 C.F.R. § 5.36, may retain their non-controlling investments in the HC after the Conversion of the Bank from its limited purpose Georgia charter to a national bank charter.

**Goodwin Procter LLP
Financial Services
Partners and Counsel**

Lynne B. Barr
Gary A. Beller
Kay E. Bondehagen
Raymond P. Boulanger
Agnes Bundy Scanlan
Margaret B. Crockett
Anna E. Dodson
Eric R. Fischer
Elizabeth Shea Fries
Jackson B.R. Galloway
James J. Kelly
Satish M. Kini
William R. Kirschner
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
Byron C. Pavano
Regina M. Pisa
Mark S. Raffman
Derek N. Steingarten
William E. Stern
Michael P. Whalen

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

Other Items of Note

➤ **GAO Issues Report on Hedge Funds**

The GAO issued a report that (1) describes how federal financial regulators oversee hedge fund-related activities under their existing authorities; (2) examines what measures investors, creditors, and counterparties have taken to impose market discipline on hedge funds; and (3) explores the potential for systemic risk from hedge fund-related activities and describes actions regulators have taken to address this risk.

➤ **FRB Proposes Changes to Its Payment Systems Risk Policy**

The FRB issued proposed changes to its Payment Systems Risk Policy (the "Policy"). The FRB stated that under the revised Policy, the FRB would supply intraday balances to healthy depository institutions "predominantly through *explicitly* collateralized daylight overdrafts provided at a zero fee." The proposed Policy would also encourage depository institutions to pledge collateral voluntarily to cover daylight overdrafts, because the FRB would substantially increase its fee for uncollateralized daylight overdrafts. The FRB stated that it believes that the proposed changes to the Policy would "help loosen liquidity constraints and reduce operational risk" in financial markets. Comments on the Policy are due no later than June 4, 2008.

➤ **FDIC Issues Guide on Deposit Insurance Coverage for Revocable and Irrevocable Trusts**

The FDIC issued an extensive guide (the "Guide") to calculating deposit insurance coverage for revocable and irrevocable trusts. The Guide discusses FDIC deposit insurance for: informal revocable trust accounts (generally, "payable on death," "in trust for" or "as trustee for" accounts stating that the funds are payable to one or more beneficiaries upon the death of the owner); formal revocable trusts (written trusts such as living or family trusts created for estate planning purposes); and irrevocable trusts (trusts established by statute or written trust agreement that cannot be terminated or voided by the guarantor). The Guide provides numerous examples of how to determine the FDIC deposit insurance coverage for each of the foregoing type of trust account.

➤ **SEC Issues Release Proposing Amendments to Form ADV Part II and Electronic Filing Requirement**

The SEC issued the formal release proposing rule and form changes that would (a) revise the content and presentation requirements for Part II of Form ADV, the registration form for advisers registered with the SEC, and (b) require registered advisers to file Part II electronically with the SEC, which would make the filings publicly available on its website. More detailed coverage of the release will appear in a future edition of the *Alert*.