

Financial Services Alert

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Developments of Note

► **FinCEN Issues Patriot Act Rule Mandating Enhanced Due Diligence for Certain Correspondent Bank Accounts**

The Financial Crimes Enforcement Network (“FinCEN”) published a final rule (the “Final Rule”) under Section 312 of the USA PATRIOT Act (“Patriot Act”) governing the enhanced due diligence procedures required for correspondent accounts maintained by U.S. covered financial institutions for certain foreign banks. *See 72 Federal Register* 44,768 (Aug. 9, 2007). The Final Rule completes FinCEN’s Section 312 rulemaking.

Section 312 of the Patriot Act requires U.S. covered financial institutions – including U.S. depository institutions, broker-dealers registered with the Securities and Exchange Commission, and mutual funds – to establish due diligence and, where necessary, enhanced due diligence policies and procedures reasonably designed to detect and report money laundering through correspondent and private banking accounts established and maintained for, respectively, foreign financial institutions and foreign persons. On January 4, 2006, FinCEN issued final rules implementing (a) the due diligence provisions of Section 312 applicable to correspondent accounts, and (b) both the due diligence and enhanced due diligence provisions of Section 312 applicable to private banking accounts. At that time, FinCEN published, and invited comment on, a proposal to implement the enhanced due diligence provisions of Section 312 with respect to correspondent accounts maintained for certain types of foreign banks.

The enhanced due diligence procedures of the Final Rule apply to “correspondent accounts” maintained for three classes of foreign “respondent banks.” As we have previously noted in the December 20, 2005 and January 30, 2006 *Alerts*, the term “correspondent account” is defined so broadly as to include essentially all accounts. Accordingly, the enhanced due diligence procedures apply to all accounts maintained for non-U.S. “respondent” banks operating under (a) an “offshore banking license” – that is, a license that prohibits the bank from generally conducting banking activities in the jurisdiction that issued the license; (b) a license issued by a country designated as non-cooperative with international money laundering principles by an international organization (such as the Financial Action Task Force) of which the United States is a member and with which designation the United States concurs; and (c) a

license issued by a country that has been designated by the U.S. Treasury Department as warranting “special measures” (under Patriot Act Section 311) due to money laundering concerns.

In the case of such accounts, the Final Rule requires enhanced due diligence procedures that encompass multiple steps. *First*, U.S. covered financial institutions must conduct risk-based “enhanced scrutiny” of correspondent accounts maintained for the above-noted classes of respondent banks. The level and nature of the enhanced scrutiny must be calibrated to reflect the covered financial institution’s risk assessment of the respondent bank’s correspondent account. The scrutiny may include, “as appropriate,” obtaining and assessing the respondent bank’s anti-money laundering program; monitoring transactions through the account; and obtaining information from the respondent bank about any persons with authority to pass transactions through a correspondent account that is a “payable-through” account and the sources and beneficial owners of funds or other assets in payable-through accounts. (Payable-through accounts allow a foreign respondent bank’s customers to conduct transactions, either directly or through a sub-account, in the United States through the respondent bank’s correspondent account.)

Second, U.S. covered financial institutions must take reasonable steps to determine whether a foreign respondent bank maintains correspondent accounts for other foreign banks and, if so, whether such second-tier foreign banks may conduct transactions through the respondent bank’s correspondent account maintained with the U.S. covered financial institution. In adopting this requirement, FinCEN clarified that it does not expect U.S. covered financial institutions will, in each case, obtain lists of foreign bank customers from their respondent banks. Instead, FinCEN requires a risk-based approach, pursuant to which a U.S. covered financial institution will make appropriate inquiries about the nature of (and types of transactions engaged in by) the foreign banks that a respondent bank serves. Only in the highest risk situations will it be necessary for a U.S. covered financial institution to obtain the identity of foreign bank customers from a respondent bank.

Third, U.S. covered financial institutions must take reasonable steps to identify the owners of a foreign respondent bank if that bank’s shares are not publicly traded. An owner is any person who directly or indirectly owns or controls 10% or more of any class of securities (whether voting or non-voting) of a respondent bank. For this purpose, members of a family generally are treated as one person.

The enhanced due diligence procedures mandated by the Final Rule will need to be applied to new correspondent accounts established on or after February 5, 2008. In addition, those procedures will need to be retroactively applied to pre-existing accounts (that is, accounts established prior to February 5, 2008) no later than May 5, 2008.

➤ **GAO Issues Report on Issues Relating to Firms that Advise Institutional Investors on Proxy Voting**

The GAO issued a report that examines the use by institutional investors of proxy voting advisory firms. The principal topics addressed in the report are: (a) potential conflicts of interest that may exist with proxy voting advisory firms that advise institutional investors on how to vote proxies, (b) the factors that might impede or promote competition in the proxy voting advisory industry, and (c) institutional investors’ use of proxy voting advisory services and the influence that those services may have on proxy voting. The GAO conducted structured interviews with 31 institutional investors selected randomly by type, including mutual funds, corporate pension funds, government pension funds and union pension funds, as well as some asset management institutions. This sample included both large and small institutional investors. The report observes that although the sample was randomly selected, its size was small and might not have been representative of the universe of institutional investors. The report does not make any recommendations.

Conflicts of Interest. The report’s discussion of potential conflicts of interests focuses significantly on the dominant proxy voting advisory firm, Institutional Shareholder Services, Inc. (“ISS”), because of the size of its client base and the scope of its operations, which include providing consulting services to

help corporations develop management proposals and improve their corporate governance. The report cites the following examples of conflicts of interest that may exist for proxy voting advisory firms *vis-à-vis* their institutional investor clients:

- A proxy voting advisory firm could be involved in helping a corporate client develop an executive compensation proposal while at the same time making a recommendation to institutional investor clients on how to vote regarding that proposal. (The report indicates that some industry observers contend that this could lead corporations to feel obligated to retain a proxy voting advisory firm for its consulting services in order to obtain favorable proxy voting recommendations.)
- Owners or executives of a proxy voting advisory firm may have a significant ownership interest in, or serve on, the board of directors of corporations that have proposals on which the firm is offering vote recommendations.
- Institutional investors that are clients of a proxy voting advisory firm may submit shareholder proposals on which the firm may be motivated to make favorable recommendations to the firm's other institutional investor clients in order to maintain the business of the institutional investors that submitted the proposals.
- Several proxy voting advisory firms are owned by companies that offer other financial services to various types of clients, thereby creating the possibility that the interests of other sets of clients may conflict with those to whom a proxy voting advisory firm is providing voting advice.

The report states that with regard to the first conflict situation noted above ISS has indicated that it has disclosed and taken steps to help mitigate the conflicts posed by such situations. Among its efforts in these areas have been the disclosure to proxy voting advisory clients of the availability of information about an issuer's use of ISS's consulting services and the maintenance of firewalls between ISS's proxy voting advisory and consulting businesses. Some institutional investors related that, in certain instances, ISS had communicated the existence of specific conflicts. All the institutional investors interviewed indicated they were satisfied with the steps taken by ISS to mitigate its potential conflicts. In addition, most institutional investors also reported conducting due diligence to obtain reasonable assurance that ISS or another proxy advisory firm was independent and free from conflicts of interest. Institutional investors also indicated that ISS's recommendations generally were not the sole basis for their proxy voting decisions. The report notes that three of the five proxy voting advisory firms (ISS, Marco Consulting Group and Proxy Governance, Inc.) were registered with the SEC under the Investment Advisers Act of 1940, as amended, and thus were subject to examination by the SEC including review of the adequacy of their controls and procedures to address conflicts of interest. The SEC reported to the GAO that it had not identified any major violations of applicable federal securities laws in its examinations of proxy voting advisory firms that are registered as investment advisers and had not initiated any enforcement action against these firms.

Factors Affecting Competition in the Proxy Voting Advisory Industry. The report acknowledges ISS's long standing position in the proxy voting advisory industry as a potential barrier to competition. The report cites the observations of industry analysts that while new market entrants need to provide comprehensive coverage of public companies and develop sophisticated information systems to provide the research and vote processing capabilities clients demand, firms interested in entering the market have access to much of the information needed to provide the necessary coverage and once the necessary technology and research processes have been acquired, the marginal costs of providing services to additional clients and of updating and maintaining these services were relatively low. The report concludes that while the new entrants in the proxy voting advisory industry have attracted some institutional clients it is too soon to tell what their ultimate impact will be in enhancing industry competition.

Influence of Proxy Voting Advisory Firms. In terms of their reliance on proxy voting advisory firms, the report finds that large institutional investors tend to rely less than small institutions on the research of specific recommendations offered by proxy voting advisory firms. Industry analysts consulted for

the report agreed that large institutions would place less emphasis than small institutions on proxy voting advisory firms' research and recommendations. All the institutional investors surveyed, however, said that they remain ultimately responsible for proxy voting divisions and retain the right to override recommendations made by proxy voting advisory firms. The report also observes that the fact that large institutional investors cast the great majority of proxy votes made by institutional investors and reportedly place less emphasis than small institutions on research and recommendations provided by proxy voting advisory firms could serve to limit the overall influence that various firms have on proxy voting results.

➤ **FRB Determines Non-Control in Private Equity Arrangements**

In a pair of letters, the FRB determined that a private equity investment arrangement with respect to Doral Financial Corporation ("Doral Financial") did not raise bank holding company control or other issues. The corporate structure of the arrangement is as follows: Doral Holdings Delaware, LLC ("Holdings LLC") would own approximately 90% of the voting shares of Doral Financial. Doral Holdings, L.P. ("Holdings LP") would contribute approximately \$627 million to Holdings LLC, and be the managing member of Holdings LLC. The sole general partner of Holdings LP ("Holdings GP") is Doral GP Ltd., a Cayman company. Holdings LLC, Holdings LP and Holdings GP are referred to as the "Doral Investment Entities." Several entities invested in various capacities in the Doral Investment Entities. This article focuses on the two principal groups that received letters from the FRB – Bear Stearns and a group of private equity investors (the "Private Equity Group").

Bear Stearns Analysis. Bear Stearns' merchant banking group ("BSMB") controls several partnerships that collectively own non-voting interests representing 4.3% of the total equity of Holdings LP. The general partner of BSMB, BSMC (another Bear Stearns' affiliate), owns another 0.2% of the total equity of Holdings LP. In addition, the general partner of BSMC owns 4.9% of the voting interests and total equity of Holdings GP. Bear Stearns is a party to a voting agreement under which Bear Stearns and 4 other investors (the Private Equity Group, as described below) each may delegate one member of the 5 member board of Holdings GP. Moreover, those five directors also would comprise 5 of the 11 directors of Doral Financial. Bear Stearns also has material financial relationships with Doral Financial, including via an advisory services agreement. Bear Stearns also entered into passivity commitments with the FRB, among other things, restricting the ability of the affiliates and directors of Bear Stearns to purchase stock of any Doral Entity.

The FRB reviewed Bear Stearns' holdings from both a grandfathered non-bank bank parent (the "Nonbank Analysis") and general Regulation Y control (the "Control Analysis") perspective. As to the Nonbank Analysis, the FRB ruled that the separate holdings of the other BSMB investors (the "BSMB Investors") need not be aggregated with the Bear Stearns' investment, even though BSMC would receive a carried interest from the holdings of BSMB Investors based upon the performance of their Doral Financial investment. In this regard, to respond to concerns that Bear Stearns and the BSMB Investors were acting collectively as an association, the parties agreed to forego a proposed clawback of the carried interest in the event the investment in Doral Financial by the BSMB Investors did not meet a specified return. As a result, Bear Stearns was not deemed to hold the more than 5% of shares or assets of another bank that is necessary to jeopardize grandfathered nonbank bank parent status.

As to the Control Analysis, the FRB determined that Bear Stearns would not meet the control tests, or even the rebuttable presumptions of control, under Regulation Y. Although the equity investments and business relationships raised concerns of managerial control, the FRB found sufficient mitigating factors existed including: (1) ownership of less than 5% of the voting securities and total equity; (2) the independence of the non-Bear Stearns BSMB Investors; (3) the fact that Bear Stearns would not be the largest investor in the Doral Investment Entities; and (4) the passivity commitments (which were attached to the letter).

The Private Equity Group. In another interpretive letter, the FRB applied the Control Analysis to four private equity investors in Doral Financial (the "Investors"). Each of the Investors would acquire

voting limited partnership interests representing between 9 and 10 percent of the total equity and voting securities of Holdings LP, and less than 10 percent of the voting shares of Holdings GP. Each of the Investors would be subject to the same shareholders agreement with Bear Stearns described above, which would result in their designation of the other 4 members of the 5 member board of Holdings GP. The Investors also entered into passivity commitments and made representations regarding their independence from the other investors in Doral Financial.

As with Bear Stearns, the FRB noted that the acquisition of significant interests and representation on the board of directors of a company that controlled Doral Financial raised Regulation Y control concerns. However, also like the Bear Stearns' analysis, the FRB found mitigating factors to determine Regulation Y control did not exist including: (1) each Investor holding less than 10 percent of the equity and voting interests; (2) the passivity commitments; and (3) the representations of each Investor regarding independence.

➤ Federal Banking Agencies Propose Illustrations for Subprime ARMs

The FRB, FDIC, OCC, OTS and NCUA (the "Agencies") issued guidance in the form of *Proposed Illustrations of Consumer Information for Subprime Mortgage Lending* (the "Illustrations") in connection with the Agencies' *Statement on Subprime Mortgage Lending* (the "Statement"), which was issued in June of 2007 (see July 10, 2007 Alert). The Statement recommends communications that ensure consumers have clear, balanced, and timely information about the relative benefits and risks of certain adjustable-rate mortgage ("ARM") products. The Illustrations are intended to assist banks in providing this information concerning certain ARM products. The Illustrations consist of: (1) an explanation of some key features and potential risks associated with a particular loan, such as the risk that the interest rate will reset at a higher level, and (2) a chart that compares payments due for a 30-year, fixed-rate mortgage and those due for a "2/28" mortgage that requires lower payments in the first two years and rapidly increasing interest rates over the remaining 28 years. The Agencies make it clear that the Illustrations are model forms and financial institutions are not required to use them. Comments must be submitted to the Agencies on or before October 15, 2007.

➤ ICI Publishes White Paper on Role of Chief Risk Officers

The Investment Company Institute published a white paper entitled *Chief Risk Officers in the Mutual Fund Industry: Who are they and what is their role in the organization?* The white paper, a project of the ICI's Risk Management Advisory Committee (the "Committee"), explores how mutual fund organizations with a chief risk officer ("CRO") have integrated that position with other positions within their organizations that have discrete risk responsibilities, such as the internal auditor, chief compliance officer, chief legal officer and other senior management. The Committee's specific goals were to examine the CRO position, the type of person serving in that role, how the position has been integrated within the firm complex and how the role of the CRO relates to those other positions within the organizations that have more discrete risk management responsibility. The white paper notes that the CRO position traditionally has been uncommon in the mutual fund industry and that those mutual fund organizations with CROs tend to be larger complexes that, in addition to the CRO position, have an internal auditor and chief legal officer.

According to the white paper, mutual fund complexes have not taken a "one-size-fits-all" approach to incorporating the CRO position into their organizations or in structuring the position. Factors such as the company culture, management team, structure, organizational style, size, geographic location(s), products offering and existence of a parent company influence the structure of the CRO position in mutual fund organizations. Participants in the survey conducted in preparing the white paper indicated that risk is "owned" by all employees of mutual fund companies, particularly by the individual business lines and that, in most instances, the positions of chief legal officer, chief compliance officer and internal auditor are responsible for risks within their respective areas, with the CRO providing tools, techniques, assessment vehicles and professional guidance to assist them in assessing, mitigating, managing and responding to risks. The white paper indicates that it is not intended to justify the

position of the CRO or encourage fund complexes to create a CRO position. Instead, the Committee hopes that the white paper will shed light on the role of CROs in the fund industry, and serve as a reference for fund complexes that, in the future, consider creating the position of CRO.

➤ **SEC Finalizes Amended Rules on Short Sale Delivery Requirements under Regulation SHO**

The SEC issued a formal release adopting amendments to Rule 200 of Regulation SHO, which provides a limited exception from the requirement that sellers of securities aggregate all of their positions in a given security to determine whether their position is net long in that security, and Rule 203 of Regulation SHO, which addresses close-out requirements for failures to deliver on short sales. Certain minor changes were made from the proposed amendments to Rule 200 in response to comments received; the amendments to Rule 203 grandfathering was adopted as proposed.

Rule 200 Amendments. Under the wording of Rule 200(e) of Regulation SHO prior to the amendments, broker-dealers may liquidate or unwind certain existing index arbitrage positions involving long baskets of stocks and short index futures or options without aggregating short positions in other proprietary accounts, as long as the sale does not occur during a period when the Dow Jones Industrial Average (“DJIA”) has declined by 2% or more below the previous day’s closing value. The amendments to Rule 200(e)(3) conform the market decline standard to changes made to NYSE Rule 80A in 2005 by referencing the NYSE Composite Index, rather than the DJIA. The amendments to Rule 200 also clarify that the 2% limitation will be determined quarterly based on the closing values during the final month of the quarter (also in conformity with the procedure in NYSE Rule 80A) and shall terminate at the end of the trading day, rather than upon establishment of the trading day’s closing value (which occurs on the next succeeding trading day).

Rule 203 Amendments. Under Rule 203 as in effect prior to the amendments, fails to deliver with regard to securities placed on the threshold list (which consists of securities with a high incidence of failures to deliver, exceeding both 0.5% of the total shares outstanding and 10,000 shares) after the short sale were grandfathered and were never subject to Regulation SHO’s close-out requirement. The amended rule provides for a 35-day (measured in consecutive settlement days) phase-in period (after effectiveness of the rule) to close out all such existing fails to deliver. In future, such fails (where the security is placed on the threshold list after the short sale but before settlement) must be closed out within 13 consecutive settlement days. Second, for Rule 144 securities which are threshold securities, the amended rule extends the required close-out period from 13 to 35 consecutive settlement days. Finally, the amended rule also extends the “pre-borrowing” requirement, which forbids any participant of a registered clearing agency and any broker-dealer for which it clears transactions from accepting short sale orders or effecting short sales for its own account without making arrangements to borrow the security in cases where any failure to deliver has been outstanding for 35 consecutive settlement days in the case of securities subject to the phase-in or for Rule 144 securities. (Under the rule prior to the amendment, the prior fails were permanently grandfathered and Rule 144 securities were subject to the 13-day limit before the pre-borrow requirement was imposed. The 13-day limit for the pre-borrowing requirement will still apply to non-Rule 144, non-phase-in securities.) The amendments are effective October 15, 2007.

➤ **NASD Amends Rule 3013 and Interpretive Material 3013 to Permit Members to Designate Co-Chief Executive Officers and Multiple Chief Compliance Officers**

The NASD amended Rule 3013 and IM-3013, which set forth the requirements for designating a Chief Compliance Officer (“CCO”) and for the annual compliance certification that must be performed by the member’s Chief Executive Officer (“CEO”). Prior to the amendment, Rule 3013 (i) required each member to designate, and identify on the member’s Form BD, a single principal to serve as the firm’s CCO for purposes of 3013 compliance, and (ii) required the member’s CEO to certify on an annual basis that the member has in place compliance and testing processes designed to ensure the member’s compliance with NASD rules, MSRB rules and the federal securities laws and regulations. Amended Rule 3013 now permits member firms to designate co-chief executive officers (co-CEOs) and multiple

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chief compliance officers (co-CCOs) to discharge the requirements of Rule 3013 and the additional requirements set forth in IM-3013.

The form of the CEO certification required by Rule 3013 is set forth in IM-3-3013, which provides that the CEO's certification must include both a statement that the member has in place certain compliance processes and a statement that the CEO has conducted one or more meetings with the CCO in the preceding 12 months to discuss the processes. IM-3013 provides that the required meetings between the CEO and CCO must include a discussion of the firm's compliance efforts as of the date of the certification and must identify and address significant compliance problems as well as any plans for emerging business areas.

IM-3013 also sets forth the level of expertise that is expected of a CCO, including the process of gaining an understanding of a member's products, services and business line functions. Because member firms may have distinct business units, such expertise may reside in more than one individual at a member firm. Recognizing this, the NASD has amended Rule 3013 to allow a member to divide the responsibility for advising the firm on its compliance scheme among the varying compliance experts within each business unit and thereby designate multiple CCOs on Schedule A of Form BD, provided that:

- (1) each designated CCO is a principal;
- (2) the member precisely defines and documents the areas of primary compliance responsibility assigned to each designated CCO and makes specific provisions for which of the designated CCOs has primary compliance responsibility in areas that can reasonably be expected to overlap;
- (3) each designated CCO satisfies all of the requirements of Rule 3013 and IM-3013 with respect to his or her defined area of primary compliance responsibility as if that individual was the firm's only CCO; and
- (4) the designated CCOs collectively have the responsibilities and expertise that enable them to consult with the CEO on the totality of the subject matters required to be addressed in the certification by the CEO under Rule 3013.

If a member chooses to have multiple CCOs, the CEO of the member must conduct one or more meetings annually between the CEO and each designated CCO, and the CEO must discuss with each CCO at each such meeting the required topics, but only as it relates to the particular CCO's defined area of primary compliance responsibility, and each CCO must review the report evidencing a member's processes and consultation by the CEO with the CCO, and the CEO must consult with each CCO prior to the CEO's 3013 certification. The NASD's amendment to Rule 3013 also permits the designation of a single co-CEO (but there may be no more than 2 CEOs) solely for the purposes of compliance with Rule 3013 and IM-3013, but each co-CEO must individually discharge all of the CEO obligations of Rule 3013 and IM-3013. The amendments to Rule 3013 and IM-3013 were effective July 16, 2007.

(Readers should be aware that effective July 30, 2007 the NASD and the member regulation, enforcement and arbitration operations of the New York Stock Exchange were consolidated into the Financial Industry Regulatory Authority ("FINRA"). Firms that were members only of the NASD as of July 30, 2007 remain subject only to NASD Rules, provided they do not become NYSE members in which case they will be subject to both NASD Rules and certain NYSE Rules that FINRA has incorporated. Similarly, a firm that becomes a new member of FINRA only (and not a member of the NYSE) will be subject only to NASD Rules.)