

# Financial Services Alert

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## *Developments of Note*

### ➤ **Federal Regulators Issue Final Statement on Subprime Mortgage Lending**

The federal banking agencies issued a final *Statement on Subprime Mortgage Lending* to address issues relating to certain subprime ARM products that can cause payment shock. The statement describes the prudent safety and soundness and consumer protection standards that banks should follow to ensure borrowers obtain loans they can afford to repay. These standards include a fully indexed, fully amortized qualification for borrowers and cautions on risk-layering features, including an expectation that stated income and reduced documentation should be accepted only if there are documented mitigating factors that clearly minimize the need for verification of a borrower's repayment capacity. Consumer protection standards include clear and balanced product disclosures to customers and limits on prepayment penalties that allow for a reasonable period of time, typically at least 60 days, for customers to refinance prior to the expiration of the initial fixed interest rate period without penalty. The final version of the statement became effective on July 10, 2007.

### ➤ **Director of SEC's Division of Investment Management Speaks at NAVA Compliance and Regulatory Affairs Conference**

At a conference sponsored by NAVA, a trade organization for the variable insurance products industry, Andrew Donohue, Director of the SEC's Division of Investment Management, reviewed current areas of focus in the Division including Rule 12b-1, revenue sharing, disclosure reform, interactive data and insurance product regulatory reforms. He noted the SEC's reexamination of Rule 12b-1 and encouraged members of the variable products industry to submit their thoughts to the Commission prior to the close of the public comment period for this initiative on July 19. In the context of revenue sharing, Mr. Donohue reiterated concerns expressed in prior public remarks regarding revenue sharing payments in the fund of funds context – in particular, payments by the adviser of a bottom tier fund to the sponsoring insurance company or its affiliates.

Turning to the topic of mixed and shared funding, Mr. Donohue noted that the Division's Office of Insurance Products is reviewing the conditions it imposes when granting individual exemptive orders allowing funds to benefit from variable life insurance separate account exemptions (under the 1940 Act rules) while allowing the underlying funds to sell their shares to variable annuity separate accounts or to unaffiliated insurance companies' separate accounts. He observed that this review is part of a broader reexamination of the variable products rules, one focus of which is to eliminate various obsolete cost provisions of the variable life rules. He noted that it may be possible to combine the scheduled and flexible premium variable life rules, and possibly the variable annuity rules as well. In closing, Mr. Donohue commented on the emerging phenomenon of baby boomers whose focus is shifting to income management from wealth accumulation and the introduction of products combining insurance guarantees with investment vehicles other than variable insurance products. He observed that where a contract is a security, it must be registered under the Securities Act of 1933, as amended, and the insurer becomes subject to the Securities Exchange Act of 1934, as amended, and Sarbanes-Oxley requirements. He added that he anticipated an interesting dialogue on these issues as insurers position themselves to address this development.

### ➤ SEC Eliminates Short Sale Price Tests

As discussed in the July 3, 2007 Alert, effective on July 3, 2007, the SEC eliminated the short sale price restrictions ("tick tests") of Rule 10a-1 under the Securities Exchange Act of 1934, as amended. The SEC also amended related rules to prohibit self-regulatory organizations ("SROs") from maintaining price tests and eliminate order marking requirements that applied to transactions relying on exceptions from the tick tests. The SEC release formally implementing these changes indicates that they do not affect other amendments to Regulation SHO also approved by the SEC in June 2007, but not yet the subject of a formal release, that tighten close-out requirements for failures to deliver on short sales by eliminating certain grandfathering provisions with respect to securities that become threshold securities (*i.e.*, are put on a list of those hard-to-buy securities that occasion a high number of failures to deliver) and make other related rule changes.

*History of the Tick Tests.* The tick tests were implemented by the SEC nearly 70 years ago to restrict short selling in a declining market. Although the core provisions of Rule 10a-1 have remained virtually unchanged, in response to changes in the securities markets, the SEC has over the years created exceptions to, and granted numerous instances of exemptive relief from, its restrictions. Requests for exemptive relief from the tick tests have increased dramatically in recent years in connection with increased automation in the securities markets. Under Regulation SHO as in effect prior to the tick tests' elimination, price restrictions applied to different securities trading in different markets and generally only to large or more actively traded securities. In some cases, price tests would apply (or not) to the short sale of a given security based on where a trade was executed.

*Pilot Program Suspending Price Tests for Certain Securities.* In 2004, the SEC enacted Regulation SHO, which established procedures for an SEC program to suspend price tests temporarily in order to assess whether changes to short sale regulation were necessary "in light of current market practices and the purposes underlying short sale regulation." The SEC conducted a pilot program during which price tests were suspended with respect to certain securities selected by the SEC from the Russell 3000 index (and, with respect to after-hours trading, the Russell 1000 index) because they were deemed relatively less susceptible to other sources of manipulation based on their capitalization and liquidity. The pilot program was undertaken to obtain data on the impact of short selling on market volatility, price efficiency and liquidity and to decide whether to remove price tests or to impose them with respect to additional securities. The SEC received four completed academic studies on the effects of the pilot program and held a public roundtable discussion in September 2006. All of the studies generally supported the removal of price tests. (See the June 29, 2004 *Alert* for a discussion of the adoption of Regulation SHO and the pilot program and the September 26, 2006 *Alert* for a discussion of the SEC roundtable on the pilot program.)

### ➤ SEC Staff Provides Guidance on the Application of FIN 48 to Registered Funds

In response to a request for interpretive guidance on the implementation of Financial Accounting Standards Board (“FASB”) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (“FIN 48”), the staff of the SEC’s Office of the Chief Accountant and the Division of Investment Management issued a letter (the “Guidance”) providing guidance on (a) when FIN 48 should be applied to uncertain tax positions for registered funds and (b) whether a practice followed by an adviser or other party of paying a fund’s liabilities may be considered a “past administrative practice” under FIN 48. FIN 48 is designed to clarify the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. In summary, under FIN 48, a fund must determine whether a tax position, based on its technical merits, meets a recognition threshold that it is more likely than not that the position will be sustained upon examination by the relevant taxing authority; this determination is based on the individual facts and circumstances of the position evaluated in light of all available evidence. If an uncertain tax position does not meet this threshold then the tax benefit of that uncertain tax position cannot be recognized until it is either ultimately settled with the taxing authority or the statute of limitations for examination has passed. The Guidance responded to a request that funds be allowed adequate time for to resolve the issues associated with FIN 48 accruals, and for clarification that a fund need not reduce its net asset value (“NAV”) in respect of a tax liability when it has been the administrative practice of the fund’s adviser or another relevant party to pay or reimburse a fund for errors the adviser or other party has made.

*Timing of the Application of FIN 48 and Compliance Matters.* The request for guidance suggested that a fund should not record a tax liability in its NAV if no reduction is required by an analysis performed under FASB Statement No. 5, *Accounting for Contingencies* (“Statement 5”), and if the fund believes no accrual is required under that approach, allowing the fund a period until the end of the quarter, but in no event greater than 45 days, to resolve the issue prior to applying FIN 48. The SEC staff disagreed with this approach and indicated that the accounting for a tax position should be performed in accordance with FIN 48 for all NAV calculations. The Guidance includes a non-exclusive list of steps a fund may take in assessing whether a tax issue exists. The SEC staff went on to state that it expected a fund to exercise reasonable diligence in gathering the relevant information regarding a potential tax issue and should adjust NAV accordingly when a tax position does not meet the recognition criteria in FIN 48. Furthermore, the SEC staff indicated that a fund should make every effort to evaluate uncertain tax positions expeditiously and not unduly delay recording tax liabilities in NAV calculations. The SEC staff observed that generally, it is not appropriate for a fund to delay recording a tax liability in NAV if the fund has the relevant information to assess the technical merits of the tax position and concludes that it does not meet the recognition criteria in FIN 48. The SEC expects that funds will adopt appropriate procedures, which may incorporate the evaluative steps listed in the Guidance, and that the procedures will ensure that all relevant parties consider tax implications when launching new products, making new investments or making operational changes to a fund. The SEC staff also expects funds to have adequate documentation supporting the accounting treatment for uncertain tax positions.

*Tax Liability Indemnification as Past Administrative Practice.* The request for guidance also sought the SEC staff’s concurrence with the view that an adviser’s or other party’s practice of making a fund whole for tax liabilities could be treated as a “past administrative practice” under FIN 48, which could be considered by the fund in determining whether to reduce its NAV as a result of a tax liability. The SEC staff’s guidance noted that past administrative practice (as used in paragraph 7(b) of FIN 48) is limited to widely understood dealings with the taxing authority and should not be extended to an adviser’s or other relevant party’s practice of making a fund whole. Instead, funds should refer to the recognition criteria and other areas of GAAP when accounting for indemnification receivables. The Guidance indicates that GAAP establishes a probable threshold with respect to the recognition of indemnification receivables by analogy to EITF Issue No. 01-10, *Accounting for the Impact of the Terrorist Attacks of September 11, 2001*, and its reference to AICPA Statement of Position 96-1, *Environmental Remediation Liabilities*. The SEC staff indicated that based on this guidance, an

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adviser's or other relevant party's contractual obligation to indemnify uncertain tax positions generally would be sufficient in demonstrating that the likelihood of recovery is probable. The process of obtaining a contractual obligation to indemnify uncertain tax positions may occur simultaneously with a fund's gathering of the relevant information used to assess whether a liability should be recorded to NAV. In these circumstances, the SEC staff indicated that it would generally view recognition of an indemnification receivable to the extent of recovery of the tax accrual as an acceptable practice. Subsequently, if the uncertain tax position were effectively settled as provided for in FASB Staff Position No. FIN 48-1 (as discussed in the May 8, 2007 *Alert*), both the tax accrual and any related indemnification receivable would need to be derecognized.

➤ **Basel Committee Chairman Discusses Basel II Pillars**

Dr. Nout Wellink, Chairman of the Basel Committee on Banking Supervision ("Basel Committee"), spoke about the banking industry trends (*i.e.*, movement away from a buy-and-hold strategy to an originate-to-distribute or market-based model) that created the need for the Basel II capital framework, as well as some of the issues with each of the three Basel II Pillars. As to Pillar 1, credit risk, Dr. Wellink stated that the Basel Committee has noted that since the beginning of the development of Basel II in the late 1990s there have been substantial advances in operational risk measurement and management. In addition, the Basel Committee has seen advances in risk transfer and mitigation in securitization and credit derivatives, and the proper assessment of capital for ever growing trading books. As to Pillar 2, supervisory review, Dr. Wellink states that "bank management bears the primary responsibility for ensuring that the bank maintains adequate capital to support the risks beyond the minimum requirements." He states that excessive participation by, or reliance upon, supervisors in determining appropriate capital is contrary to the objectives of Basel II, and if banks demonstrate that they are properly managing risks, active supervisory involvement in capital determinations should be reduced. Further as to Pillar 2, Dr. Wellnick noted that he understands that more work needs to be done on home-host issues for Basel II to realize its full potential.

Finally, Dr. Wellnick recognizes that much less focus has been given to Pillar 3, the public disclosure and market discipline component of Basel II. He states that Pillar 3 will help enhance discipline around risk measures because banks will be required to show the actual outcomes versus the estimates. He notes that challenges remain with Pillar 3, as banks have expressed concern about misinterpretation of the complex disclosures by investors and the marketplace, and also have concerns about inconsistencies in the disclosures across banks. Dr. Wellnick stated that more extensive dialogue involving supervisors, banks, and market participants will be "necessary to prevent any unintended consequences."

➤ **FDIC Announces that Insured Financial Institutions Will be able to Exchange Examination Information with State Regulators Through FDICconnect**

The FDIC announced that, starting July 9, 2007, FDIC-insured financial institutions ("FIs") and their data servicers became able to exchange examination information securely with participating state bank regulators through the FDIC's FDICconnect Examination File Exchange system. FDIC-regulated FIs already may use the FDICconnect system to submit examination-related information to the FDIC. The FDIC stated that it "encourages all [FIs] to take advantage of this system when contacted by the FDIC and/or a state banking regulator for information before or during an examination."

***Other Item of Note***

➤ **SEC to Consider Adopting Advisers Act Anti-Fraud Rule Designed to Protect Investors in Pooled Vehicles**

At its open meeting scheduled for Wednesday, July 11, the SEC will consider whether to adopt a new anti-fraud rule under Section 206 of the Investment Advisers Act of 1940, as amended, that would prohibit advisers to certain pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles. A January 8, 2007

Client Alert discussing the rule as proposed is available on the firm's website at [http://www.goodwinprocter.com/Files/Publications/CA\\_AntiFraudRules\\_1\\_8\\_07.pdf](http://www.goodwinprocter.com/Files/Publications/CA_AntiFraudRules_1_8_07.pdf).