

Financial Services Alert

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Developments of Note

➤ **Federal Agencies Issue Final Interagency Statement Concerning Complex Structured Finance Transactions**

The SEC, FRB, FDIC, OCC and OTS (collectively, the "Agencies") issued a final interagency statement (the "Final Statement") on sound practices concerning elevated risk complex structured finance transactions ("CSFTs"). The Final Statement describes the types of internal controls and risk management procedures that the Agencies believe will assist banks, bank holding companies, savings and loan associations, savings and loan holding companies, US branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers to identify CSFTs that may pose heightened legal or reputational risks to the institution ("Elevated Risk CSFTs") and to evaluate, manage and address these risks within the institution's internal control framework. The Final Statement reflects the Agencies' response to industry comments received on a proposed statement on this topic that was issued for comment in May 2006 (the "Revised Proposed Statement"). The Revised Proposed Statement is discussed in the May 23, 2006 issue of the *Alert*. The Final Statement became effective on January 11, 2007.

Like the Revised Proposed Statement, the Final Statement acknowledges that most structured finance transactions that are familiar in the marketplace and involve vehicles that have a well-established track record would not normally be considered Elevated Risk CSFTs. Such non-problematic transactions would include standard public credit card securitizations, asset-backed commercial paper programs, hedging programs involving "plain vanilla" derivatives and collateralized loan obligations. Elevated Risk CSFTs, on the other hand, would include new transactions that lack economic substance, involve circular transfers of risk, are designed for questionable accounting, regulatory or tax objectives or involve undocumented agreements that would have a material impact on the regulatory, tax or accounting treatment of the transaction or on the client's disclosure obligations or that have material economic terms that are inconsistent with market norms or that provide the financial institution with

compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market or operational risk assumed by the institution.

Like the Revised Proposed Statement, the Final Statement eschews prescriptive rules in favor of a principles-based approach that relies largely on an institution's general risk management systems to identify and address Elevated Risk CSFTs. In particular, it provides that institutions should put in place systems to address the following aspects of the vetting process for Elevated CSFTs: (1) due diligence (commensurate with the risk identified); (2) approval (ensuring that appropriate levels of control and management personnel are involved); (3) documentation (*e.g.*, material terms/obligations, required customer disclosures, verification of adequate process); (4) general business ethics, including setting a "tone at the top" to reinforce the importance of compliance and overall good business ethics; (5) reporting to the institution's management and board of directors; (6) monitoring compliance with internal policies and procedures, including periodic independent reviews; (7) audit, including transaction testing; and (8) training.

The provisions described above are very similar to those in the Revised Proposed Statement. However, in response to industry comments the Agencies have clarified them in several respects, as described below.

Approval and Diligence Procedures. The Final Statement clarifies that a U.S. branch or agency of a foreign bank is not necessarily expected to establish or adopt separate U.S.-based risk management structures or policies for its CSFT activities. However, the adopting release for the Final Statement states that the risk management structure and policies used by a U.S. branch or agency should be effective in allowing the branch or agency to manage the risks associated with its CSFT activities, whether adopted or implemented on a group-wide or stand-alone basis.

Documentation. The Final Statement recognizes that the documentation provided to senior management for approval does not have to detail every aspect of the institution's legal or business analysis of the transaction, and that the minutes of an institution's reviewing senior management committee may have the information about a transaction described, as long as the documentation reflects the factors considered by senior management in taking action. In addition, the list of documentation required to be retained has been modified to include sufficient documentation to establish that the institution has provided the customer with any disclosures concerning an Elevated Risk CSFT that the institution is otherwise required to provide to the customer. This cuts back a requirement in the Revised Proposed Statement for the institution to receive and maintain documentation establishing that the customer has received any and all required disclosures regarding the transaction, rather than only those that the institution is required to provide.

Independent Review Function. The Final Statement clarifies that required periodic independent reviews of an institution's CSFT activities in order to verify implementation of the institution's policies and procedures may be performed by the institution's audit department or by an independent compliance function within the institution. However, the Agencies rejected suggestions from commentators to acknowledge that the role of the independent review function is limited to monitoring compliance with processes and that the function should not assess the quality of the decisions made. In doing so, they expressed the view that an institution's audit or compliance department should have the flexibility, in appropriate circumstances, to review the decisions made by institution personnel during the review and approval process for Elevated Risk CSFTs.

Like the Revised Proposed Statement, the Final Statement expressly states that it does not create any private rights of action, and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other third parties under applicable law.

➤ **FinCEN Issues Report to Congress Stating that Reporting of Cross-Border Wire Transfer Data is Technically Feasible but Should be Limited to Approximately 25% of Banks**

FinCEN issued a report (the “Report”) to Congress required under Section 6302 of the Intelligence Reform and Terrorism Prevention Act of 2004. The Report concludes that the reporting of cross-border wire transfer data by financial institutions “is technically feasible for the government and may be valuable to the government’s efforts to combat money laundering and terrorist financing.”

The Report states that only financial institutions that directly send money to or accept money from sources abroad should be required to report details on wire transfers to FinCEN. This would limit compliance with the regulations to approximately 25% of financial institutions, most of whom would be larger financial institutions. FinCEN also suggests in the Report that reporting should be limited to single transactions of \$3,000 or more, data which financial institutions are currently required to retain under Section 21 of the Federal Deposit Insurance Act. The Report stresses that cross-border fund transfer data would be technologically protected and secure, and access to the data would be limited to FinCEN and certain law enforcement and regulatory agencies. FinCEN proposes in the Report that the reporting requirements be implemented through a multi-phase, incremental process that would take three years or more to complete.

➤ **Congress Amends Regulatory Relief Act**

On January 11, 2007, the President signed into law H.R.6345, an act making a conforming amendment to the Federal Deposit Insurance Act to permit banking agencies to apply an extended 18-month examination cycle to CAMELS “2” rated depository institutions with assets of up to \$500 million. The legislation makes a technical change to clarify that expanded eligibility for the extended 18-month examination cycle included in the Financial Services Regulatory Relief Act of 2006 (the “Regulatory Relief Act”) should apply to both “1” and “2” rated banks, rather than only “1” rated banks. Section 605 of the Regulatory Relief Act increased the maximum asset size of institutions eligible for the extended 18-month exam cycle from \$250 million to \$500 million. The October 2, 2006 Special Edition of the *Alert* summarized the key provisions of the Regulatory Relief Act. Agency and congressional staff have indicated that intended Section 605 to apply to both “1” and “2” rated banks, but as drafted the provision inadvertently limited relief to “1” rated institutions.

➤ **FRB Governor Bies Discusses Mortgage Lending Issues**

Governor Bies of the FRB made two presentations regarding mortgage lending. The first discussed general principles of enterprise risk management (“ERM”) and how ERM programs can be useful in assessing and addressing risks in mortgage lending operations, particularly the risks identified in the joint guidance issued by the federal banking agencies on nontraditional mortgage lending last September (“Joint Guidance”). (See the *Alert* of October 3, 2006 for more information on the Joint Guidance.) In the second presentation, Governor Bies gave an overview of current economic activity, including some indication that the downshift in the housing market may be stabilizing. In her second speech, Governor Bies provided a summary of the role the FRB plays in consumer protection, using the Joint Guidance as a current example of promoting consumer awareness and maintaining consumer protection so that consumers fully understand the financial products they obtain and their associated risks.

Other Items of Note

➤ **Goodwin Procter Client Alert Regarding SEC Proposals for New Advisers Act Anti-Fraud Rule and Modified Accredited Investor Standard for Individuals Investing in Certain 3(c)(1) Funds Now Available on Firm’s Website**

Goodwin Procter has posted a Client Alert discussing the SEC’s proposals for (a) a new anti-fraud rule under the Investment Advisers Act of 1940, as amended, and (b) a modified accredited investor

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standard under the Securities Act of 1933, as amended, for investments by natural persons in certain funds relying on Section 3(c)(1) of the Investment Company Act of 1940, as amended, on the firm's website at http://www.goodwinprocter.com/Files/Publications/CA_AntiFraudRules_1_8_07.pdf.

➤ **SEC Issues Formal Releases Adopting Proxy Rule Changes to Permit Delivery Via Website Posting of Proxy Materials and Proposing Mandatory Website Delivery of Proxy Materials**

The SEC issued formal releases describing action taken at its December 13, 2006 meeting to (a) adopt amendments to its proxy rules that permit issuers and others conducting proxy solicitations to do so by posting proxy materials on an Internet website and providing shareholders with notice of that availability (the "Notice and Access Model") and (b) propose proxy rule amendments that mandate use of the Notice and Access Model for all solicitations not related to a business combination transaction (as discussed in the December 19, 2006 *Alert*). Issuers and others may begin using the Notice and Access Model no sooner than July 1, 2007. Comments on the proposal to make the Notice and Access Model mandatory should be received by the SEC within 60 days of the proposal's publication in the Federal Register. Next week's *Alert* will discuss the releases in greater detail.