

# Financial Services Alert

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## *Developments of Note*

### ➤ U.S. Treasury, FRB and FDIC Announce and Provide Detail on Programs to Support Financial Institutions In Response to Recent Market Instability

On October 14, 2008, Secretary of the Treasury Henry Paulson, FRB Chairman Benjamin Bernanke and FDIC Chairman Sheila Bair formally announced and provided further detail on two new programs, the TARP Capital Purchase Program (the "Capital Purchase Program") and the Temporary Liquidity Guarantee Program (the "Liquidity Program"), designed to strengthen public confidence in the U.S. financial system and address the crisis in the credit markets. The Treasury announced that through voluntary participation in the Capital Purchase Program, financial institutions may sell preferred shares to the U.S. government. The Treasury further announced that it is seeking comments on a program that would guarantee the principal of, and interest on, troubled assets originated or issued prior to March 14, 2008. The FDIC also announced that under the Liquidity Program it will temporarily (i) guarantee newly issued senior unsecured debt of any FDIC-insured depository institution and certain bank and savings and loan holding companies engaged only in financial activities, and (ii) offer full deposit insurance coverage of non-interest bearing deposit transaction accounts, regardless of dollar amount.

These actions were taken to implement the comprehensive global strategy outlined by the Group of Seven nations to address the current instability in the financial markets and to mitigate the risks such instability poses to the broader economy. Following the G-7 meeting, the FRB announced that it will provide unlimited dollar funds to the Bank of England, the Swiss National Bank and the European Central Bank. The Treasury and FRB have previously announced plans to purchase certain illiquid mortgage-backed assets held by financial institutions and commercial paper. The Capital Purchase Program expands the scope of the Troubled Asset Relief Program ("TARP") from buying such illiquid

mortgage-backed assets to directly capitalizing financial institutions. The Treasury announced that it will initially invest \$125 billion in nine large financial institutions under the Capital Purchase Program. In addition, the FRB provided further detail concerning the previously announced Commercial Paper Funding Facility. Please see our discussion of the FRB's Commercial Paper Funding Facility in the article below.

*I. Treasury Action: TARP Capital Purchase Program*

Under the authority of the Emergency Economic Stabilization Act of 2008 (the "EESA"), the Treasury will make available \$250 billion of capital to U.S. financial institutions through the Capital Purchase Program. This \$250 billion is part of the \$700 billion authorized by Congress for the TARP. Under the Capital Purchase Program, the Treasury will purchase up to \$250 billion of senior preferred shares on standardized terms as described in the Capital Purchase Program's term sheet (the "Senior Preferred Shares"). The Capital Purchase Program will be available to qualifying U.S.-controlled banks, savings associations, and certain bank and savings and loan holding companies engaged only in financial activities that elect to participate before 5:00 pm (EDT) on November 14, 2008. The Treasury will determine eligibility and allocations for interested financial institutions after consultation with the appropriate federal banking regulator. Financial institutions interested in participating in the Capital Purchase Program are requested to contact their primary federal regulator for specific enrollment details.

Senior Preferred Shares

*Size and Security.* The minimum subscription amount available to a participating financial institution will be one percent of its risk-weighted assets. The maximum subscription amount will be the lesser of \$25 billion or three percent of risk-weighted assets. The Treasury will fund the Senior Preferred Shares purchased under the Capital Purchase Program by year-end 2008. The Senior Preferred Shares will have a liquidation preference of \$1,000 per share; however, the Treasury may agree to a higher liquidation preference per share depending upon the participating financial institution's available authorized preferred shares.

*Ranking, Term and Dividend.* The Senior Preferred Shares will qualify as Tier 1 capital and will rank senior to common stock and pari passu with existing preferred shares, other than preferred shares which by their terms rank junior to any other existing preferred shares. The Senior Preferred Shares will have a perpetual life. The Senior Preferred Shares will pay cumulative dividends at a rate of five percent per year for the first five years and will reset to a rate of nine percent per year after the fifth year. For Senior Preferred Shares issued by banks which are not subsidiaries of holding companies, the Senior Preferred Shares will pay non-cumulative dividends at a rate of five percent per year for the first five years and will reset to a rate of nine percent per year after the fifth year. The dividends of Senior Preferred Shares will be payable quarterly in arrears on February 15, May 15, August 15 and November 15 of each year.

*Redemption.* The Senior Preferred Shares will be callable at par after three years, including any accrued and unpaid dividends for the cumulative Senior Preferred Shares or any accrued and unpaid dividends for the then current dividend period for the non-cumulative Senior Preferred Shares (regardless of whether any dividends are actually declared for such dividend period). Redemptions of Senior Preferred Shares will be subject to the approval of the participating financial institution's primary federal bank regulator. Prior to the end of three years, the Senior Preferred Shares may be redeemed with the proceeds from a qualifying equity offering of any Tier 1 perpetual preferred or common stock ("Qualifying Equity Offering") which results in aggregate gross proceeds to the participating financial institution of not less than 25 percent of the issue price of the Senior Preferred Shares.

*Dividend Restrictions.* For as long as any Senior Preferred Shares are outstanding, no dividend may be declared or paid on any junior preferred shares, preferred shares ranking pari passu with the Senior

Preferred Shares, or common shares unless all the accrued and unpaid dividends for the cumulative Senior Preferred Shares are fully paid or all the full dividend for the latest completed dividend period for the non-cumulative Senior Preferred Shares has been declared and paid in full. Dividends may be declared on pari passu preferred shares on a pro rata basis with the Senior Preferred Shares.

Participating financial institutions also may not repurchase or redeem any junior preferred shares, preferred shares ranking pari passu with the Senior Preferred Shares or common shares unless all the accrued and unpaid dividends for the cumulative Senior Preferred Shares are fully paid or all the full dividend for the latest completed dividend period for the non-cumulative Senior Preferred Shares has been declared and paid in full. Consent of the Treasury will be required for any increase in common dividends per share for the first three years, unless prior to the end of three years the Senior Preferred Shares have been redeemed in full or the Treasury has transferred all of the Senior Preferred Shares to third parties.

*Repurchases.* The consent of the Treasury will be required for any share repurchases, other than repurchases of the Senior Preferred Shares or junior preferred shares or common shares in connection with any benefit plan in the ordinary course of business consistent with past practice, for the first three years, unless prior to the end of three years the Senior Preferred Shares have been redeemed in full or the Treasury has transferred all of the Senior Preferred Shares to third parties. No repurchases of junior preferred shares, preferred shares ranking pari passu with the Senior Preferred Shares or common shares will be allowed if such repurchase is prohibited by a restriction on dividends.

*Voting Rights.* The Senior Preferred Shares will be non-voting, except for class voting rights on matters that could adversely affect the shares, such as an issuance of senior ranking shares, any amendment to the rights of the Senior Preferred Shares, or any merger, exchange or similar transaction. If dividends on the Senior Preferred Shares are not paid in full for six dividend periods, whether or not consecutive, the Senior Preferred Shares will have the right to elect 2 directors. This right to elect directors will end when full dividends have been paid for four consecutive dividend periods.

*Transferability.* The Treasury may also transfer the Senior Preferred Shares to a third party at any time. The participating financial institution must promptly file a shelf registration statement covering the Senior Preferred Shares and shall take all action to cause such shelf registration to be declared effective as soon as possible. The participating financial institution must also grant the Treasury piggyback registration rights for the Senior Preferred Shares and will take such other steps as reasonably requested to facilitate the transfer of the Senior Preferred Shares, including, if requested, reasonable efforts to list the Senior Preferred shares on a national securities exchange. At the request of the Treasury, the participating financial institution will appoint a depository to hold the Senior Preferred Shares and issue depository receipts.

#### Warrants

In conjunction with the purchase of Senior Preferred Shares, the Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15 percent of its investment in Senior Preferred Shares. The exercise price on the warrants will be the market price of the participating financial institution's common stock at the time of issuance, calculated on a 20-trading day trailing average. The warrants will have a term of 10 years and will be immediately exercisable, in whole or in part. The warrants will be freely transferable, however, the Treasury may only transfer or exercise an aggregate of one-half of the warrants prior to the earlier of (i) the date on which the participating financial institution has received aggregate gross proceeds of at least one hundred percent of the issue price of the Senior Preferred Shares from one or more Qualifying Equity Offerings or (ii) December 31, 2009. The participating financial institution must promptly file a shelf registration statement covering the warrants and the underlying common stock and shall take all action to cause such shelf registration to be declared effective as soon as possible. The participating financial institution must also grant the Treasury piggyback registration rights for the warrants and underlying common stock and will take such other steps as reasonably requested to facilitate the transfer of the warrants and underlying common stock. The participating financial institution shall list the underlying common stock on the

same national securities exchange on which its common shares are traded. The Treasury will not exercise the voting rights of any common stock issued to it upon exercise of the warrants.

In the event that the participating financial institution has received aggregate gross proceeds of at least one hundred percent of the issue price of the Senior Preferred Shares from one or more Qualifying Equity Offerings on or prior to December 31, 2009, the number of shares of common stock underlying the warrants then held by the Treasury shall be reduced by a number of shares equal to the product of (i) the number of shares originally underlying the warrants (taking into account all adjustments) and (ii) 0.5. In the event that the participating financial institution does not have sufficient available authorized shares of common stock to reserve for issuance upon exercise of the warrants and/or stockholder approval is required for such issuance under applicable stock exchange rules, the participating financial institution will call a meeting of its stockholders as soon as possible after the investment to increase the number of authorized shares of common stock and/or comply with such exchange rules, and take any other measures the Treasury deems necessary to allow the exercise of warrants into common stock. In the event the participating financial institution is no longer listed or traded on a national securities exchange or securities association, or the required consent of the institution's stockholders has not been obtained within 18 months after the issuance date of the warrants, the warrants will be exchangeable, at the option of the Treasury, for senior term debt or another economic instrument or security of the institution such that the Treasury is appropriately compensated for the value of the warrant, at its so determines.

#### Executive Compensation and Corporate Governance Restrictions

Any financial institution participating in the Capital Purchase Program will be subject to stringent executive compensation and corporate governance rules for the period during which Treasury holds equity or debt issued under the Capital Purchase Program. A participating financial institution must meet certain standards, including: (1) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution; (2) requiring "clawback" of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; (3) prohibiting the financial institution from making any golden parachute payment to a senior executive based on the Internal Revenue Code provision; and (4) agreeing not to deduct for tax purposes executive compensation in excess of \$500,000 for each senior executive. These standards generally apply to the chief executive officer, chief financial officer, plus the next three most highly compensated executive officers. As a condition of closing an investment, participating financial institutions shall modify or terminate all benefit plans, arrangements and agreements to the extent necessary to be in compliance with such standards. The institution and any officers covered by the standards shall grant the Treasury a waiver releasing the Treasury from any claims that the institution or such officer may otherwise have as a result of the issuance of any regulation which modify the terms of benefits plans, arrangement and agreements to eliminate any provisions that would not be in compliance with the executive compensation and corporate governance standards. The Treasury has issued interim final rules for these executive compensation standards.

#### Initial Participants

Nine large financial institutions have already agreed to participate in the Capital Purchase Program. In an investment totaling \$125 billion, the Treasury will buy \$25 billion each in Senior Preferred Shares of Citigroup, J.P. Morgan Chase, Bank of America (including Merrill Lynch) and Wells Fargo (including Wachovia); \$10 billion each in Senior Preferred Shares of Goldman Sachs and Morgan Stanley; \$3 billion in Senior Preferred Shares of The Bank of New York Mellon; and approximately \$2 billion in Senior Preferred Shares of State Street. These institutions have voluntarily agreed to participate on the same terms that will be available to small and medium-sized banks and thrifts across the nation. The remaining \$125 billion of the Capital Purchase Program will be allocated among thousands of small and midsize financial institutions. Such institutions will be eligible for government investments reflecting a similar proportion of their assets.

## II. Request for Comment on Guarantee Program for Troubled Assets

The Treasury has requested comment on establishing a program under the EESA to guarantee the principal of, and interest on, troubled assets originated or issued prior to March 14, 2008. Such program may take any form and may vary by asset class, but must be voluntary and self-funding. Premiums may be set to reflect the credit risk characteristics of the insured assets so as to ensure that taxpayers are fully protected. The Treasury invites comment on how the program should be structured to minimize adverse selection, including how premiums should be calculated, what events should trigger insurance payout, what form that payout should take, and which institutions and assets should be eligible. The Treasury also asks for public comment on technical considerations, including what legal, accounting, or regulatory issues would arise and what administrative challenges the program will create. Comments are due by Friday, October 28, 2008.

## III. FDIC Action: Temporary Liquidity Guarantee Program

Under its authority to prevent systemic risk, the FDIC announced the Liquidity Program to strengthen confidence and encourage liquidity in the banking system. The Liquidity Program has two components: (i) a guarantee of newly issued senior unsecured debt of any FDIC-insured depository institution and certain bank and savings and loan holding companies engaged only in financial activities, and (ii) full deposit insurance coverage of non-interest bearing deposit transaction accounts, regardless of dollar amount.

### Guarantee of Newly Issued Senior Unsecured Debt

Under the Liquidity Program, certain newly issued senior unsecured debt issued on or before June 30, 2009, will be fully protected in the event the issuing institution subsequently fails, or its holding company files for bankruptcy. This includes promissory notes, commercial paper, inter-bank funding, and any unsecured portion of secured debt. The amount of debt of the issuing institution covered by the guarantee may not exceed 125% of its debt that was outstanding as of September 30, 2008 and that was scheduled to mature before June 30, 2009. Coverage will be limited to June 30, 2012, even if the maturity of the debt extends beyond that date. The FDIC will not provide protection to “troubled” institutions. The FDIC stated that it will issue further guidance specifying the process for utilizing the Liquidity Program.

### Full Deposit Insurance Coverage of Non-Interest Bearing Deposit Transaction Accounts

In addition, any participating depository institution will be able to provide full deposit insurance coverage for non-interest bearing deposit transaction accounts, regardless of dollar amount. These include payment-processing accounts, such as payroll accounts used by businesses. Frequently, the balance of such accounts exceeds the current deposit insurance limit of \$250,000. This increased deposit insurance coverage will expire on December 31, 2009.

### Liquidity Program Fees

The Liquidity Program will not be funded with taxpayer funds or through the Deposit Insurance Fund. Rather, financial institutions participating in the Liquidity Program will be charged a 75 basis point fee on the amount of debt guaranteed by the Liquidity Program and a 10 basis point surcharge will be applied to non-interest bearing transaction accounts that would not otherwise be covered by the existing deposit limit of \$250,000 and added to the participating institution’s current insurance assessment.

## Liquidity Program Coverage

All FDIC-insured institutions will be covered immediately under the program for the first 30 days without incurring any costs. After that initial period, however, institutions no longer wishing to participate must opt out or be assessed for future participation. If an institution opts out, the guarantees will only cover the initial 30 day period. All opt outs are final; once an institution opts out, it cannot re-enter the Liquidity Program. Financial institutions participating in the Liquidity Program will be subject to enhanced supervisory oversight to prevent rapid growth or excessive risk taking. The FDIC will maintain control over eligibility in consultation with the participating institution's primary federal regulator. Participation in the Liquidity Program will not trigger executive compensation restrictions. The FDIC will issue rules for the Liquidity Program in the upcoming weeks, including what form of customer notification is necessary for newly insured deposits under the Liquidity Program or when a financial institution opts out of the Liquidity Program.

### ➤ FRB Announces Lending Program to Aid Commercial Paper Market

The FRB announced that it was creating a new program (the "Program") under Section 13(3) of the Federal Reserve Act to aid the commercial paper ("CP") market. CP is unsecured, short-term debt issued by certain (generally large) business organizations (including both financial and non-financial companies).

Under the Program, which will be administered by The Federal Reserve Bank of New York (the "FRB-NY"), the FRB will establish a special purpose vehicle ("SPV"), and the FRB-NY will commit to lend to the SPV at a target federal funds rate. The SPV will draw down on the FRB-NY lending facility on an overnight basis with recourse to the SPV. The lending will be secured by all SPV assets as well as other security.

The SPV will purchase three-month unsecured and asset-based CP from eligible issuers through the FRB-NY's primary dealers. Eligible issuers will include U.S. issuers of CP, including U.S. issuers with foreign parents. The SPV will finance "only highly rated U.S. dollar-denominated three-month" CP. With respect to non-asset-backed CP, the SPV will receive as additional security unspecified up-front fees or other inducements from the CP issuer, or guaranties, collateral or other forms of security acceptable to the FRB. The maximum amount of CP that an issuer may sell to the SPV is the greatest amount of U.S. dollar-denominated CP the issuer had outstanding on any day between January 1, 2008 and August 31, 2008. The SPV will not purchase additional CP from an issuer whose total CP outstanding to all investors (including the SPV) equals or exceeds the foregoing maximum amount. The FRB stated that pricing will be based on the then current three-month overnight index swap rate plus fixed spreads. The SPV will cease to purchase CP under the Program on April 30, 2009. The FRB, however, will continue to fund the SPV until the SPV's underlying assets mature. The SPV will begin purchases of CP on October 27, 2008.

### ➤ DOL Issues Final Rule Regarding Statutory Exemption for Cross-Trading

The Department of Labor (the "DOL") issued a final rule relating to the new statutory prohibited transaction exemption for cross-trading under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Pension Protection Act of 2006 added a new Section 408(b)(19) to ERISA, which provides relief for certain cross-trades between large plans. Specifically, the new statutory exemption provides relief for the purchase and sale of a security between a plan and another account managed by the same manager if certain requirements are satisfied. One requirement is that the manager must establish policies and procedures that are fair and equitable to all accounts, including policies and procedures for allocating cross-trades, and must designate an individual responsible for periodically reviewing cross-trades for compliance with such policies and procedures. The final rule is substantially similar to the interim final rule (see the February 27, 2007 Alert). Clarifications and modifications to the interim final rule include (i) a requirement that the policies and procedures include a statement regarding the manager's conflicting loyalties and how the manager will mitigate such

conflicts, (ii) compliance reviews may be performed using a sampling methodology provided such methodology is disclosed in the policies and procedures, (iii) every plan participating in a collective fund or other pooled account covered by the exemption must satisfy the minimum \$100 million plan size requirement, (iv) the minimum plan size requirement need only be verified on an annual (rather than quarterly) basis, and (v) individual portfolio managers of the same entity may rely on the exemption. Although the DOL refused to state that the exemption may be relied upon for cross-trades by affiliated managers, the DOL indicated that such cross-trades would not constitute a per se violation of Section 406(b)(2) of ERISA. However, a violation of ERISA's fiduciary rules could result if there was an agreement or understanding between the parties to favor one party or client. The final rule becomes effective on February 4, 2009.

### ➤ Update on Treasury Temporary Guarantee Program Developments

As discussed in the October 7, 2008 *Alert*, all money market funds that intend to participate in the U.S. Treasury's Temporary Guarantee Program (the "Program") were required to have filed applications with the Treasury and paid the appropriate fees on or before October 8, 2008, or in certain circumstances, October 10, 2008. Since the October 7, 2008 *Alert*, there have been further developments with respect to the Program.

- The Staff of the SEC's Division of Investment Management issued to the Investment Company Institute (the "ICI") a no-action letter stating that it would not recommend any enforcement action against a money market fund participating in the Program for violating the senior securities prohibitions of Section 18(f) of the Investment Company Act of 1940, as amended (the "1940 Act").
- The Treasury and the Internal Revenue Service (the "IRS") issued guidance for an insurance-dedicated money market fund participating in the Program, that is, a money market fund whose beneficial interests are held exclusively by one or more segregated asset accounts of one or more insurance companies or other investors permitted under Section 1.817-5(f)(3) of the Treasury regulations under the Internal Revenue Code of 1986, as amended (the "Code"). Under that guidance, the Treasury and the IRS addressed two issues. First, they stated that a segregated asset account that invests in an insurance-dedicated money market fund will not violate the diversification requirements of Section 817(h) of the Code. Second, they stated that a fund's participation in the Program will not cause the holder of a variable contract supported by a segregated asset account that invests in the fund to be treated as an owner of the fund.
- The Treasury issued an supplementary Q&A for the Program, in which it stated, among other things, that:
  - Although there is no explicit requirement for a participating money market fund to shadow price each day, the fund's agreement with the Treasury requires it to notify the Treasury promptly if there is a Guarantee Event (generally defined as when the fund's net asset value calculated using market quotations (its "market-based net asset value") falls below \$0.995) or if the fund's market-based net asset value per share falls below a threshold value (generally, \$0.9975 per share). The Treasury stated that whether or not a fund should shadow price daily in order to meet those notification and reporting requirements "is one that must be made in light of the specific facts and circumstances applicable to each individual fund."
  - A fund may "cure" a Guarantee Event if its market-based net asset value increases above the Guarantee Threshold Value (generally, \$0.995 per share) before the fund is required to commence liquidation. In general, if the fund has a good faith belief that the market-based net asset value will increase above the Guarantee Threshold Value in a "short period of time" or the fund seeks to obtain a NAV Support Agreement (generally, an agreement under which a third party provides assistance in maintaining a fund's \$1.00 share price), the fund may take the full five days to commence liquidation. If during that period the

market-based net asset value per share equals or exceeds the Guarantee Threshold Value, the fund will be deemed to have cured the Guarantee Event.

- The AICPA Audit and Accounting Guide for Investment Companies suggests that premiums paid by a fund to participate in the Program should be treated as a fund expense. Moreover, the premium paid should be reflected on the fund's books as a prepaid asset and that expenses should be amortized over the period beginning as soon as the fund determines that it will participate in the Program and ending on December 18, 2008.

#### ➤ **FRB Grants Exemption to Permit Bank Purchase of Affiliated Money Market Fund Assets**

In a letter dated October 6, 2008 (the "Letter"), the FRB approved the request of a bank to purchase assets of an affiliated money market mutual fund in excess of the bank's affiliate transaction limits under FRB Regulation W. The bank made the request so that the funds could meet redemption requests without having to sell assets "into the currently fragile and illiquid money markets." The Letter made the approval subject to the following conditions: (1) the bank only could purchase assets from registered 2a-7 funds; (2) the purchase would be limited to the lesser of the amount necessary to cover redemptions or a specified dollar amount; (3) the assets purchased would be externally rated by an NRSRO at A1/P1 or the equivalent; (4) the bank only could purchase the assets at fair market value as determined by a third-party pricing service; (5) the bank's parent would reimburse the bank for any losses the bank incurred in connection with the purchase; (6) the parent and the bank would remain "well capitalized"; and (7) the purchases of assets from the funds would occur on or before a specified date.

#### ➤ **FRB Issues Statement on Mitsubishi UFJ Investment in Morgan Stanley**

On October 8, 2008, the FRB issued a statement regarding its October 6, 2008 approval of the application under section 3 of the Bank Holding Company Act and notices by Mitsubishi UFJ Financial Group, Inc. ("Mitsubishi"), a financial holding company and the largest banking organization in Japan, to acquire a noncontrolling interest in up to 24.9% of the voting shares of Morgan Stanley, New York, New York, a leading U.S. investment bank that recently became a registered bank holding company. (*Statement by the Board of Governors of the Federal Reserve System Regarding the Application and Notices by Mitsubishi UFJ Financial Group, Inc., to Acquire Interests in a Bank Holding Company and Certain Nonbanking Subsidiaries By Order dated October 6, 2008 (the "FRB Statement")*).

The FRB Statement provides additional information concerning the first significant noncontrolling investment in a bank holding company under the FRB's September 22, 2008 guidance on minority investments in banks and bank holding companies (the "Guidance"). The Guidance provides limited additional leeway for minority investments in banks and bank holding companies, including investments that may exceed 25% of total equity of the bank or bank holding company and sizeable voting investments accompanied by an interlock in certain circumstances. (For additional discussion of the Guidance, see the September 23, 2008 *Alert*).

According to the FRB Statement, Mitsubishi's investment will be passive. The investment may not exceed 24.9% of voting shares without additional FRB approval. Mitsubishi committed not to exercise or attempt to exercise a controlling influence over the management or policies of Morgan Stanley or any of its subsidiaries. In addition, Mitsubishi committed not to have more than one representative serve on the board of directors of Morgan Stanley or its subsidiaries. (An additional Mitsubishi representative may observe board meetings.) Mitsubishi's commitments include restrictions on the business relationships between Mitsubishi and Morgan Stanley, the details of which were not specified in the FRB Statement.

The financial press reported that on October 13, 2008 Treasury officials were prepared to provide assurances to Mitsubishi that "any future government investment in Morgan Stanley wouldn't wipe out [Mitsubishi's] investment." Press reports also indicate that the investment was revised over the weekend of October 11-12, 2008 to consist of convertible and nonconvertible preferred stock on terms

more favorable to Mitsubishi, eliminating a common stock component contained in the original investment proposal.

### ➤ **SEC Permits Money Market Funds Temporarily to Use Amortized Cost in Shadow Pricing**

The Staff of the SEC's Division of Investment Management recently issued a no-action letter (the "No-Action Letter") to the Investment Company Institute (the "ICI") in which it stated that it would not recommend enforcement action against a money market fund that maintains a stable net asset value per share if the money market fund, in complying with the "shadow pricing" requirement of Rule 2a-7 under the Investment Company Act of 1940, as amended, uses the amortized cost valuation method to value certain securities when calculating its market-based net asset value per share. Subject to a number of conditions, Rule 2a-7 permits a money market fund to calculate its share price for purposes of issuing and redeeming shares using the amortized cost method of valuing portfolio securities, rather than market values or, in the absence of readily available market quotations, fair value as otherwise required. One of the conditions imposed by Rule 2a-7 on a fund using the amortized cost method is that the fund must adopt procedures requiring the fund periodically to "shadow price," that is, determine the extent that the fund's current net asset value per share calculated using the amortized cost valuation method deviates from its net asset value per share calculated using valuations based on available market quotations or appropriate substitutes that reflect current market conditions.

In its request for no-action relief, the ICI argued that under current market conditions, the shadow pricing provisions of Rule 2a-7 are not working as intended because of the difficulty funds were experiencing in obtaining market prices for certain securities. The SEC's no-action relief will permit a fund to use the amortized cost value of a security, rather than the security's market price or an appropriate substitute, for shadow pricing, provided that (a) the security (i) has a remaining maturity of 60 days or less and (ii) is a First Tier Security (as defined in Rule 2a-7, which is generally a security in the highest short-term ratings categories of two or more nationally recognized statistical ratings organizations, or unrated but of comparable quality) and (b) the fund reasonably expects to hold the security to maturity. In addition, a fund may not rely upon the No-Action Letter with respect to any security if the impairment of the creditworthiness of the issuer of the security suggests that the use of amortized cost no longer is appropriate. Funds may rely on the relief in the No-Action Letter through January 12, 2009.

### ➤ **FASB Issues Final Draft of Staff Position 157-3 Regarding Fair Valuation of Financial Assets When Markets for that Asset are Not Active**

The Financial Accounting Standards Board (the "FASB") issued its final staff position "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active," FAS 157-3, effective October 10, 2008. FAS 157-3 is substantially similar to the FASB's proposed interpretative guidance published for comment on October 3, 2008 and discussed in the October 7, 2008 *Alert*. FAS 157-3 also clarifies, among other things, that determining fair value in a dislocated market depends on facts and circumstances and may require significant judgment about whether individual transactions are forced liquidations or distressed sales. Responding to comments on the proposed interpretative guidance, the FASB also clarified that when distinguishing between an active market and an inactive market, practitioners should (i) look to the market for a particular asset or class of assets being measured rather than the overall market and (ii) consider the factors that characterize an inactive market, such as a decline in the volume and level of activity, prices that are not current, and prices that vary substantially.

### ➤ **FDIC Increases Deposit Insurance Premiums**

As reported in the October 7, 2008 *Alert*, effective October 3, 2008, the FDIC temporarily increased the limit on federal deposit insurance coverage from \$100,000 to \$250,000 per depositor. The increase in coverage terminates on December 31, 2009.

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On October 7, 2008, the FDIC Board of Directors issued a notice of proposed rulemaking (the "NPR") by which the FDIC proposes to increase bank deposit premium rates significantly to recapitalize the FDIC's Deposit Insurance Fund (the "DIF") and to make the premium rates more sensitive to the risks presented by the applicable banking institution to the DIF. At the same time, the NPR would change the factors used to calculate deposit premiums. Factors that would raise a bank's deposit premium would include excessive use of brokered deposits and excessive use of secured liabilities.

Currently banks pay from 5 basis points to 43 basis points for deposit insurance. Under the NPR, assessment rate categories would initially be, uniformly increased by 7 basis points (annualized) for the quarter beginning January 1, 2009. Premiums for "well-capitalized" CAMELS 1- and 2- rated banks would increase from a range of 5-7 basis points to a range of 12-14 basis points. For subsequent quarters, adjustments would be made to increase the deposit premium burden borne by banks that, in the view of the FDIC, pose the greatest risk to the DIF. The FDIC also decided to maintain the DIF's Designated Reserve Ratio at 1.25 percent. The FDIC also stated that the changes proposed in the NPR are intended to ensure that the [Designated Reserve Ratio] returns to 1.15 percent by the end of 2013."

## *Other Item of Note*

### ➤ **SEC Reopens Comment Period on Proposed Rules Regarding Registration of Certain Indexed Annuities and Related Exclusion from 1934 Act Reporting**

The SEC reopened the comment period on (a) proposed Rule 151A under the Securities Act of 1933 (the "1933 Act"), which would define certain indexed annuities as falling outside the exclusion for registration otherwise provided for annuity contracts under Section 3(a)(8) of the 1933 Act and (b) proposed Rule 12h-7 under the Securities Exchange Act of 1934 (the "1934 Act"), which would provide an insurance company with an exemption from 1934 Act reporting with respect to certain registered securities issued by the company and regulated as insurance under state law. (See the July 1, 2008 *Alert* for additional detail on the proposed rules.) The reopened comment period ends 30 days after publication of the release formally announcing this SEC action in the Federal Register.