

# Financial Services Alert

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## *In this issue:*

### *Developments of Note*

1. The Treasury, FDIC, FRB, OCC and OTS Release Application Guidelines for the TARP Capital Purchase Program
2. IRS Issues Guidance to Promote Bank Participation in the TARP Capital Purchase Program
3. FRB Adopts Interim Final Rule on Treatment of Senior Preferred Shares Issued to the Treasury under the TARP Capital Purchase Program
4. FRB Announces Creation of Money Market Investor Funding Facility
5. DOL Releases Interpretive Bulletins on the Consideration of Outside Factors in Making Investment Decisions and Exercising Shareholder Rights
6. SEC Adopts Anti-Fraud Rule for Naked Short Sales
7. SEC Eliminates Regulation SHO Options Market Maker Exception and Provides Guidance on Bona Fide Marketing for Purposes of the Reg SHO Market Maker Exception
8. SEC Adopts Interim Final Temporary Rule Requiring Delivery on Long and Short Sales and Imposing Penalties for Failures to Deliver
9. Banking Agencies Allow Banking Organizations that Incurred Losses on Fannie Mae/Freddie Mac Preferred Stock To Recognize them as Ordinary Losses for Regulatory Capital Purposes in 3<sup>rd</sup> Quarter of 2008

### *Other Items of Note*

10. SEC Adopts Interim Final Rule 10a-3T Requiring Institutional Managers to Report Certain Short Positions to the SEC on Form SH
11. FDIC Makes Available Updated Trust Examination Manual

## *Developments of Note*

### ➤ **The Treasury, FDIC, FRB, OCC and OTS Release Application Guidelines for the TARP Capital Purchase Program**

On October 20, 2008, the Treasury, in conjunction with the FDIC, FRB, OCC and OTS (collectively, the “Federal Banking Agencies”), released application guidelines for financial institutions interested in participating in the TARP Capital Purchase Program (the “CPP”). For a detailed discussion of the CPP, please see the October 14, 2008 *Alert*. To apply for the CPP, financial institutions should review the CPP terms and conditions available on the Treasury’s website and consult with their primary federal regulator. After this consultation, qualified and interested financial institutions must submit an application to that regulator. Bank holding company applicants should submit applications to both their holding company supervisor and the supervisor of the largest insured depository institution controlled by the applicant. A single, standardized application form has been finalized by the Treasury in consultation with the Federal Banking Agencies. The application requires the applicant to submit basic information about the institution, the amount of perpetual preferred shares the institution is requesting that the Treasury purchase under the CPP, and information regarding the amount of authorized but unissued common and preferred stock the institution currently has available for purchase. To ensure

consistency, the Treasury has worked with the Federal Banking Agencies to establish a streamlined and standardized process to review all applications. Once a Federal Banking Agency has reviewed an application, it will send the application and its recommendation to the Treasury's Office of Financial Stability. The Treasury will review the application and determine whether to make the capital purchase. In his public remarks on October 20, 2008, Treasury Secretary Henry Paulson stated that the Treasury will give considerable weight to the recommendations by the Federal Banking Agencies. All capital purchase transactions will be announced within 48 hours of execution. There will be no public announcement of applications that are withdrawn or denied.

The terms for the CPP are the same for all financial institutions. A summary term sheet is currently available on the Treasury's website and a detailed investment agreement and associated documentation will be soon be posted on the website. Each applicant must obtain and review a copy of the CPP agreement and agree to all of the terms and conditions, including representations and warranties, contained in the agreement. Applicants also must identify and describe any mergers, acquisitions or other capital raisings that are currently pending or under negotiation along with the expected consummation date of such transactions. Any applicant desiring confidential treatment of specific portions of the application must submit a request in writing with the application that discusses the justification for the confidential treatment. If a financial institution files an application prior to the availability of the investment agreement and associated documentation, the applicant must file an amended application which includes updated responses to any items in the application that required prior review of the investment agreement. In the event that an applicant cannot, by November 14, 2008, take action to be in compliance with all of the terms and conditions, including the representations and warranties, contained in the investment agreement, the applicant must provide with their application an explanation of the condition or conditions that cannot be met and the reasons the condition or conditions cannot be met. Upon receiving the Treasury's preliminary approval to participate in the CPP, the applicant will have 30 days following the date of notification to submit the investment agreement and related documentation.

All capital purchases under the CPP will occur at the highest-tier holding company in cases which the financial institution has a bank holding company or a savings and loan holding company. In such cases, the capital purchased by the Treasury under the CPP will be cumulative senior perpetual preferred shares of the highest tier holding company. In the case of an insured depository institution that is not controlled by a holding company, the capital eligible for purchase by the Treasury under the CPP will be non-cumulative senior perpetual preferred shares of the insured depository institution. The shares purchased under the CPP must be pari passu with the most senior preferred shares available by the applicant. As previously discussed in the *Alert*, the maximum amount of capital eligible for purchase by the Treasury under the CPP is the lesser of (i) an amount equal to 3 percent of the total risk-weighted assets of the applicant or (ii) \$25 billion. The minimum amount eligible for purchase under the CPP is the amount equal to 1 percent of the total risk-weighted assets of the applicant. All measurements will be based on the information contained in the latest quarterly supervisory report filed by the applicant with its primary federal regulator updated to reflect events materially affecting the financial condition of the applicant occurring since the filing of such report.

In his remarks, Secretary Paulson stated that sufficient capital has been allocated to allow all qualifying banks the opportunity to participate in the CPP. He further stressed that the CPP is not being implemented on a first-come-first-served basis.

The application form for participation in the CPP is currently available on the websites of the Treasury and each of the Federal Banking Agencies. All applications must be submitted no later than 5 p.m. (EST) on November 14, 2008.

### ➤ **IRS Issues Guidance to Promote Bank Participation in the TARP Capital Purchase Program**

The Internal Revenue Service (the "IRS") on October 14, 2008 issued Notices 2008-100 and 2008-101 (the "Notices") to provide guidance to banks participating in the Federal government's Capital Purchase

Program (the “CPP”), included as part of the Emergency Economic Stabilization Act of 2008’s Troubled Asset Relief Program (the “TARP”). The Notices provide for exceptions to the application of certain provisions of Sections 382 and 597 of the Internal Revenue Code of 1986 (the “Code”) in the case of capital infusions from the Treasury Department pursuant to the CCP. Notice 2008-100 provides guidance to corporations regarding the application of Section 382 of the Code. Notice 2008-101 provides guidance regarding the application of the “Federal financial assistance” provision contained in Section 597 of the Code.

Notice 2008-100 provides that any shares of stock of a bank acquired by the Treasury Department pursuant to the CPP shall not be considered to have caused an ownership change with respect to the Treasury Department’s ownership of the stock of such bank. In general, Section 382 of the Code limits a corporation’s deduction for net operating loss carryovers and recognized built-in losses subsequent to an ownership change. An ownership change, as defined in section 382(g) of the Code, is, generally, a change of 50% or more of the ownership of a corporation within a three-year period. Prior to Notice 2008-100, the Treasury Department’s acquisition of certain stock of a bank under the CPP could have resulted in an ownership change, thereby limiting the bank’s ability to utilize prior losses to reduce its taxable income.

Additionally, Notice 2008-100 provides that shares of stock of a bank redeemed from the Treasury Department shall be treated as if they had never been outstanding for purposes of determining if such redemption has effected an ownership change with respect to other shareholders. Furthermore, Notice 2008-100 provides guidance concerning (i) the effect of the CPP on a bank’s status as a member or parent of an affiliated group, (ii) the Treasury Department’s acquisition of warrants to purchase bank stock, and (iii) the treatment of options acquired by the Treasury Department. Notice 2008-100 further provides that, for purposes of Section 382(l)(1) of the Code, any capital infusion made by the Treasury Department in a bank pursuant to the CPP shall not be considered to have been made as part of a plan a principal purpose of which was to avoid or increase any limitation imposed by Section 382 of the Code.

Notice 2008-101 provides that no amount furnished by the Treasury Department to a bank pursuant to the TARP shall be treated as “financial assistance” within the meaning of Section 597 of the Code. Section 597 of the Code generally treats money and other property received by a bank from the Federal Deposit Insurance Corporation as “Federal financial assistance.” Such assistance is generally treated as taxable income to the recipient bank and, prior to Notice 2008-101, could have included the Treasury Department’s acquisition of certain stock of the bank under the TARP.

Banks may rely on the guidance contained in the Notices unless and until the IRS issues further guidance. While the IRS intends to issue regulations that set forth the rules described in Notice 2008-100, such regulations will not apply, however, to acquisitions by the Treasury Department prior to the publication of such regulations or pursuant to written binding contracts entered into prior to the publication of such regulations.

### ➤ **FRB Adopts Interim Final Rule on Treatment of Senior Preferred Shares Issued to the Treasury under the TARP Capital Purchase Program**

The FRB adopted an interim final rule (the “Rule”) on the treatment of senior perpetual preferred shares (“Senior Preferred Shares”) issued to the Treasury pursuant to the TARP Capital Purchase Program (the “CPP”). For a complete discussion of the CPP, please see the discussion in the October 14, 2008 *Alert*. The Rule specifically permits bank holding companies to include without limit all Senior Preferred Shares issued under the CPP in Tier 1 capital for purposes of the FRB’s risk-based and leverage capital rules and guidelines for bank holding companies.

The FRB noted that some features of the Senior Preferred Shares would otherwise render it ineligible for Tier 1 capital treatment or limit its inclusion in Tier 1 capital under the FRB’s capital guidelines for bank holding companies. The amount of cumulative perpetual preferred stock that a bank holding company may include in its Tier 1 capital is currently subject to a 25 percent limit. Further, bank

holding companies may not include in Tier 1 capital perpetual preferred stock, whether cumulative or non-cumulative, that has a step-up dividend rate. The terms of the Senior Preferred Shares call for an initial dividend rate of 5%, which increases to 9% after five years. The FRB has long expressed concern that a step-up dividend rate undermines the permanence of a capital instrument and poses safety and soundness concerns. The FRB recognizes, however, that Senior Preferred Shares are being issued with the strong public policy objective of increasing capital available to banking organizations and include features designed to incentivize issuers to redeem Senior Preferred Shares and replace such shares with private qualifying Tier 1 capital as soon as practicable. A bank holding company may only redeem Senior Preferred Shares with the approval of the FRB. The FRB strongly cautions bank holding companies against construing the inclusion of Senior Preferred Shares in Tier 1 capital as in any way detracting from the FRB's longstanding stance regarding the unacceptability of a rate step-up in other regulatory capital instruments.

The FRB stated that it expects bank holding companies that issue Senior Preferred Shares to hold capital commensurate with the level and nature of the risks to which they are exposed. The FRB further expects such bank holding companies to appropriately incorporate the dividend features of the Senior Preferred Shares into their liquidity and capital funding plans.

The Rule was effective October 17, 2008; however, the FRB is seeking public comment on the Rule. Comments must be submitted within 30 days of the publication of the Rule in the *Federal Register*, which is expected soon.

#### ➤ **FRB Announces Creation of Money Market Investor Funding Facility**

The FRB announced the creation of the Money Market Investor Funding Facility ("MMIFF"), which is designed to support a private-sector initiative providing liquidity to investors in U.S. money market instruments. Under the MMIFF, the Federal Reserve Bank of New York (the "FRBNY") will provide senior secured funding to a series of special purpose vehicles established by the private sector ("PSPVs") that will purchase from eligible investors at amortized cost eligible money market instruments. Eligible investors initially will consist only of U.S. money market mutual funds. The FRB announcement did not state whether a money market fund must maintain a stable net asset value or share price to be eligible. Money market instruments eligible for purchase by PSPVs will include U.S. dollar-denominated certificates of deposit, bank notes, and commercial paper with a remaining maturity of 90 days or less. A PSPV will finance the purchase of each eligible asset by (a) issuing asset-backed commercial paper that is rated at least A-1/P-1/F1 by two or more major nationally recognized statistical rating organizations ("NRSROs") in an amount equal to 10% of the purchase price and (b) obtaining a loan equal to 90% of the purchase price from the FRBNY. Each PSPV will only purchase debt instruments issued by ten financial institutions designated in its operational documents. Each of these financial institutions must have a short-term debt rating of at least A-1/P-1/F1 from two or more major NRSROs. Each PSPV will cease purchasing assets and will enter a winding down process on April 30, 2009, unless the FRB extends the MMIFF. The FRB has issued a term sheet describing the basic terms and operational details of the facility, which is available at <http://www.federalreserve.gov/newsevents/press/monetary/monetary20081021a1.pdf>.

#### ➤ **DOL Releases Interpretive Bulletins on the Consideration of Outside Factors in Making Investment Decisions and Exercising Shareholder Rights**

The Department of Labor (the "DOL") released two interpretive bulletins, Interpretive Bulletin 08-1 ("I.B. 08-1") and Interpretive Bulletin 08-2 ("I.B. 08-2"), under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), restating and clarifying prior guidance regarding fiduciary obligations when considering economically targeted investments and shareholder rights.

I.B. 08-1 addresses those circumstances in which ERISA plan fiduciaries may consider factors other than the economic interests of the plan in making investment decisions. According to the DOL, when making investment decisions ERISA plan fiduciaries may consider factors other than the economic

interests of the plan only if the investment alternatives are equal, taking into account all relevant qualitative and quantitative factors, including the level of diversification, degree of liquidity and the potential risk/return. The DOL noted that to protect any such investment decisions from challenge, ERISA plan fiduciaries should create a written record of the economic analysis undertaken to demonstrate that the investment alternatives were determined to be of equal value.

I.B. 08-2 similarly addresses ERISA plan fiduciary obligations in considering factors other than the plan's economic interests in the context of proxy voting, statements of investment policy and shareholder activism. The DOL states that in voting proxies, ERISA plan fiduciaries may consider only those factors that relate to the economic value of the plan's investment – including whether the cost of voting the proxy outweighs the expected economic benefit of voting – regardless of whether any such vote is made pursuant to a statement of investment policy. Further, the DOL states that while ERISA plan fiduciaries generally satisfy their fiduciary obligations by acting pursuant to a statement of investment policy, ERISA plan fiduciaries may vote in compliance with and act pursuant to a statement of investment policy only to the extent that doing so would be prudent and solely in the economic interest of plan participants. ERISA plan fiduciaries, including those that select or monitor other fiduciaries, should carefully consider whether their objectives or actions are motivated or influenced by objectives unrelated to the economic interests of the plan.

### ➤ SEC Adopts Anti-Fraud Rule for Naked Short Sales

The SEC adopted Rule 10b-21 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), substantially as proposed in March 2008 (see the March 25, 2008 *Alert*), and as included in the SEC's emergency order of September 17, 2008 (see the September 18, 2008 *Alert*), which expired on October 17, 2008. Rule 10b-21 is intended to address failures to deliver securities sold short that have been associated with “naked” short selling. Rule 10b-21 forbids “any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date.” Scienter (as understood under the existing anti-fraud standard of Exchange Act Rule 10b-5) is required for a violation of the Rule. Similar to Regulation SHO, the Rule applies only to equity securities.

In the release adopting Rule 10b-21, the SEC noted that naked short selling as part of a manipulative scheme was already illegal under the general antifraud provisions of the federal securities laws, but that it believes that a rule further evidencing the illegality of these activities will focus the attention of market participants on such activities. To clarify the Rule's relationship to other anti-fraud rules, SEC added a preliminary note to the Rule stating that Rule 10b-21 “is not intended to limit, or restrict, the applicability of the general antifraud provisions of the federal securities laws.” In response to comments received on Rule 10b-21 as proposed, the SEC noted that the courts have held that a private right of action exists with respect to Rule 10b-5 provided the essential elements constituting a violation of the rule are met. Thus, a private plaintiff able to prove all those elements in a situation covered by Rule 10b-21 would be able to assert a claim under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Rule 10b-21 became effective on October 17, 2008.

### ➤ SEC Eliminates Regulation SHO Options Market Maker Exception and Provides Guidance on Bona Fide Marketing for Purposes of the Reg SHO Market Maker Exception

The SEC amended Regulation SHO to eliminate the options market maker exception to the Regulation's close out provisions for threshold securities (as defined in the Regulation). The October 17, 2008 effectiveness of this amendment made permanent the temporary repeal of this exception effected by the SEC's September 17, 2008 emergency order (the “September Emergency Order”) (as discussed in the September 18, 2008 *Alert*), which expired on October 17, 2008.

Under the amendments, all fails to deliver in a threshold security resulting from short sales by a registered options market maker effected to establish or maintain a hedge on options positions

established before the security became a threshold security will, like all other fails to deliver in threshold securities, have to be closed out in accordance with the close-out requirements of Regulation SHO. The adoption of the amendments does not alter or add to the one-time 35 day phase-in period running from the effectiveness of the September Emergency Order.

In addition, the amendments prohibit any participant in a registered clearing agency (and any broker-dealer for which it clears transactions, including any market maker) from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.

The SEC also provided some additional new guidance regarding what it considers to constitute “bona fide” market making activity for purposes of the market maker exception to Regulation SHO’s “locate” requirement. The SEC provided specific factors it would consider in determining what constitutes bona fide market making, indicating that the following factors would weigh in favor of finding that a dealer was engaged in bona fide market making: (1) when a dealer incurs economic or market risk with respect to the securities (*e.g.*, by putting its own capital at risk to provide continuous two-sided quotes in markets); (2) when a dealer engages in a trading pattern that includes both purchases and sales in roughly comparable amounts to provide liquidity to customers or other broker-dealers; (3) in the course of fulfilling its obligations as a market maker, when a dealer provides liquidity to a security’s market, takes the other side of trades when there are short-term buy-and-sell-side imbalances in customer orders, or attempts to prevent excess volatility. Under the SEC guidance all such activities will result in the market maker assuming some market risk with respect to a particular trade or a related set of trades. This guidance places a heightened importance on the assumption of market risk in determining whether a dealer is engaged in bona fide market making. In addition to guidance regarding what would be considered bona fide market making, the SEC also provided additional examples of what would not be considered bona fide market making, including: (1) a market maker that continually executes short sales away from its posted quotes, and (2) a market maker that posts continually at or near the best offer, but does not also post at or near the best bid.

### ➤ SEC Adopts Interim Final Temporary Rule Requiring Delivery on Long and Short Sales and Imposing Penalties for Failures to Deliver

The SEC adopted interim final temporary Rule 204T, which (1) prohibits clearing brokers from failing to deliver shares on both long and short sales by the settlement date and (2) imposes penalties on both clearing brokers and the broker-dealers who send them trades for clearance and settlement, including market makers, when a clearing broker does not close out failures to deliver on long and short sales within the timeframes specified in the interim final temporary rule. The interim final temporary rule is in effect an extension of temporary Rule 204T as adopted in the SEC’s September 17, 2008 Emergency Order (see the September 18, 2008 *Alert* for more detail on this Emergency Order), which expired October 17, 2008, but includes some modifications to address operational and technical concerns raised with respect to the temporary rule adopted in the September Emergency Order. The interim final temporary rule also incorporates some of the guidance provided by the SEC staff in Frequently Asked Questions (“FAQs”) regarding temporary Rule 204T, which were issued subsequent to the September 17, 2008 Emergency Order (see the September 23, 2008 *Alert* for discussion of those FAQs). The interim final temporary rule is effective from October 17, 2008 until July 31, 2009. Because Rule 204T is an interim final temporary rule, the SEC must act no later than July 31, 2009 if it intends to maintain requirements the same as, or similar to, those in the interim final temporary rule, thereafter. The SEC has requested comment on the interim final temporary rule. Comments should be received on or before December 16, 2008.

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### ➤ **Banking Agencies Allow Banking Organizations that Incurred Losses on Fannie Mae/Freddie Mac Preferred Stock To Recognize them as Ordinary Losses for Regulatory Capital Purposes in 3<sup>rd</sup> Quarter of 2008**

The federal banking agencies (the “Agencies”) will allow banks, bank holding companies and thrifts to recognize the effect of a tax change enacted in Section 301 of the Emergency Economic Stabilization Act of 2008 (the “EESA”) in their regulatory capital calculations for the third quarter of 2008.

Section 301 of the EESA allows banking organizations that incurred losses on Fannie Mae and Freddie Mac preferred stock to recognize them as ordinary rather than capital losses for regulatory capital purposes. Because the EESA was not enacted until October 3, 2008, banking organizations would not have been able to take advantage of the new tax treatment until the fourth quarter. Pursuant to the Agencies’ decision, however, banking organizations may recognize their Fannie Mae and Freddie Mac losses for regulatory capital purposes in the third quarter of 2008.

The Agencies also plan to provide regulatory reporting instructions on the tax change to guide banking organizations on measuring regulatory capital in their regulatory capital reports for the third quarter of 2008.

## *Other Items of Note*

### ➤ **SEC Adopts Interim Final Rule 10a-3T Requiring Institutional Managers to Report Certain Short Positions to the SEC on Form SH**

The SEC adopted new interim final Rule 10a-3T under the Securities Exchange Act of 1934, as amended. The interim final rule requires certain large institutional managers (i.e., those with \$100 million or more in assets under management) to report to the SEC on Form SH their short positions in “13f” securities, other than options. Rule 10a-3T is in effect an extension of the emergency order issued by the SEC on September 17, 2008 (the “September 17th Order”, as amended on September 21, 2008), which required managers to file non-public Form SH reports with the SEC regarding short positions in 13f securities and which expired at midnight on October 17, 2008. Rule 10a-3T became effective on Saturday, October 18th, 2008 and will continue through August 1st 2009. For more on Rule 10a-3T, see the October 16, 2008 Special Edition of the *Alert* at <http://www.goodwinprocter.com/~media/987D2C24C1D14EA3B605795B685BEF61.ashx>.

### ➤ **FDIC Makes Available Updated Trust Examination Manual**

The FDIC made available an updated version of its *Trust Examination Manual* (the “Manual”). Revisions to the Manual include guidance concerning: SEC/FRB Regulation R and Gramm-Leach-Bliley Act exceptions from the definition of “broker” under the Securities Exchange Act of 1934; IRS and Department of Labor treatment of health savings accounts and abandoned employee benefit plans; and changes enacted in the Pension Protection Act of 2006, and their impact on IRAs and other ERISA-governed employee benefit plans.