

# Financial Services Alert

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## *Developments of Note*

### ➤ SEC Staff Grants No-Action Relief Allowing Non-U.S. Funds to Participate with Affiliated U.S. Mutual Funds in Joint Credit Facility

The staff of the SEC's Division of Investment Management (the "Staff") issued a no-action letter in which it provided assurances that it would not recommend enforcement action under Section 17(d) of the Investment Company Act of 1940, as amended (the "1940 Act"), and Rule 17d-1 thereunder, if U.S. open-end investment companies registered under the 1940 Act (the "U.S. Funds") and certain foreign open-end investment funds (the "Foreign Funds," and together with the U.S. Funds, the "Funds"), all managed by affiliated advisers, entered into a joint global, unsecured, senior committed line of credit with a syndicate of global banks (the "Global Credit Facility") designed to provide the Funds with a source of cash for temporary and emergency purposes to meet unanticipated or unusually large redemption requests by shareholders. Relief was sought out of concern that because each Fund would pay a portion of the fees associated with the Global Credit Facility, it could run afoul of the prohibitions in Section 17(d) and Rule 17d-1, which in general terms do not permit an affiliated person of a mutual fund acting as principal to effect any transaction in which the fund is a joint or joint and several participant.

The structure of the Global Credit Facility would be in all material respects the same as joint credit facilities for which the Staff has previously given no-action relief, except for the participation of Foreign Funds. The Staff observed that the Foreign Funds' participation did not materially change the analysis of the Global Credit Facility under Section 17(d) and Rule 17d-1. It therefore conditioned the requested relief on receipt of the representations provided with respect to prior no-action relief regarding joint credit facilities. The Staff also required the following representations with respect to the Foreign Funds: (i) in making their initial and subsequent annual best interest determinations about participation in the Global Credit Facility, each U.S. Fund's board of trustees, including a majority of the independent trustees, will consider any unique issues presented by participating in the facility with Foreign Funds and (ii) regardless of whether the law of any foreign jurisdiction imposes any limits on

borrowing by a Foreign Fund, at a minimum, no Foreign Fund will be permitted to borrow under the Global Credit Facility in excess of the limit imposed on a U.S. Fund under Section 18 of the 1940 Act. While admitting that the participation of Foreign Funds was arguably a novel issue, the Staff reiterated that it will no longer respond to requests for no-action relief regarding the status of committed line of credit arrangements under Section 17(d) and Rule 17d-1 unless they present novel or unusual issues.

### ➤ **Basel Committee Issues Strategy to Respond to Banking Crisis**

The Basel Committee on Banking Supervision (“Basel Committee”), via a notice on its website and a speech by its Chairman, Nout Wellink, issued a strategy to respond to the current banking crisis. The strategy focuses on strengthening several areas of bank operation and supervision: capital buffers; liquidity risk management and buffers; risk management practices; counterparty credit risk; and globally coordinated supervision.

*Capital Buffers.* The Basel Committee does not propose to raise minimum capital ratios during a crisis. However, the Basel Committee will remain focused on several areas of risk capture, including by issuing proposals in early 2009 regarding capital treatment of off-balance sheet exposures and securitizations, strengthening the capital treatment of illiquid securities in the trading book, disclosure requirements relating to the foregoing, and reviewing the role of external ratings in the Basel II framework. The Basel Committee also will provide guidance on the key elements of the proper composition of tier 1 capital in light of recent developments, and will explore the ability of strong capital buffers to reduce the cyclical nature of lending. Moreover, the Basel Committee is reviewing whether to supplement risk-capital based approaches with “simple, transparent gross measures of risk” to “provide a further check on the build-up of leverage at financial institutions and the underestimation of risk during rapid periods of credit growth.”

*Liquidity Risk Management and Buffers.* The Basel Committee pledged to redouble its efforts to develop more consistent benchmarks for sound liquidity at global banks, including benchmarks for liquidity cushions, maturity mismatch, funding liquidity diversification, and resilience to stress. The Basel Committee also will implement its recently issued “Principles for Sound Liquidity Risk Management” (see the July 1, 2008 Alert).

*Risk Management Practices.* The Basel Committee expects the private sector to take the lead in developing risk management frameworks. Nonetheless, the Basel Committee expects to issue in 2009 further guidance on risk management with respect to securitizations, contractual and non-contractual obligations to off-balance sheet vehicles, and stress testing.

*Counterparty Credit Risk Practices.* The Basel Committee also will use the 3 pillars of Basel II to strengthen the minimum capital, risk management, and disclosure relating to counterparty credit risk and its management. The purpose of the effort is to help banks better withstand the failure of one or more major counterparties.

*Globally Coordinated Supervision.* The Basel Committee also is assessing global incompatibilities in the resolution of global banking groups. Among other things, the Basel Committee will be assessing gaps in global regulations and ways to correct them, assessing different ways to promote better risk management of participants in major payment systems and other global networks, and establishing stronger links between the objectives of central bank liquidity operations, regulation and supervision.

➤ **Troubled Asset Relief Program Developments - FRB and Treasury Create Program to Purchase Asset-Backed Securities and Treasury Issues Guidelines for the Systemically Significant Failing Institutions Program**

*Term Asset-Backed Securities Loan Facility*

The FRB announced the creation of the Term Asset-Backed Securities Loan Facility (“TALF”), a facility that will support the issuance of asset-backed securities (“ABS”) collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration (“SBA”). The set of permissible underlying credit exposures of eligible ABS may be expanded to include commercial mortgage-backed securities, non-Agency residential mortgage-backed securities, or other asset classes. Under the TALF, the Federal Reserve Bank of New York (“FRB-NY”) will lend up to \$200 billion on a non-recourse basis to U.S. holders of certain AAA-rated ABS backed by newly and recently originated consumer and small business loans. The FRB-NY will lend an amount equal to the market value of the ABS less a haircut and will be secured at all times by the ABS. The Treasury will provide \$20 billion of credit protection under the Troubled Assets Relief Program (“TARP”) to the FRB-NY in connection with the TALF. In the event that a participating investor cannot repay a loan, or does not repay a loan because the collateral has declined in value to the point that it is worth less than the loan payoff amount, that investor will incur no financial obligation beyond the loss of the collateral. The loss by the TALF will be absorbed first by the haircut on the collateral, second by the Treasury contribution, third by TALF program fees and finally by the FRB.

The FRB-NY will offer a fixed amount of loans under the TALF on a monthly basis. TALF loans will be awarded to borrowers each month based on a competitive, sealed bid auction process. Each bid must include a desired amount of credit and an interest rate spread over the one-year Overnight Index Swaps. The FRB-NY will set minimum spreads for each auction and will reserve the right to reject or declare ineligible any bid, in whole or in part, in its discretion. In this regard, the FRB-NY will develop and implement procedures to identify for further scrutiny potentially high-risk ABS that a borrower proposes to pledge to the FRB-NY under the TALF. The FRB-NY will assess a non-recourse loan fee at the inception of each loan transaction. Each borrower under the TALF must use a primary dealer, which will act as agent for the borrower, to access the TALF and must deliver eligible collateral to a clearing bank. Originators of the credit exposures underlying eligible ABS (or, in the case of SBA guaranteed loans, the ABS sponsor) must have agreed to comply with, or already be subject to, the executive compensation requirements of the Emergency Economic Stabilization Act of 2008 (“EESA”). For a discussion of the executive compensation requirements, see the October 14, 2008 *Alert* and the October 27, 2008 *Alert*. The terms and conditions of the TALF are subject to change based on discussions with market participants in the coming weeks. The TALF will cease making new loans on December 31, 2009, unless the FRB extends the facility.

*Purchases of Direct Obligations and Mortgage-backed Securities of Government-Sponsored Enterprises*

The FRB also announced that it will initiate a program to purchase the direct obligations of housing-related government-sponsored enterprises (“GSEs”)—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—and mortgage-backed securities (“MBS”) backed by Fannie Mae, Freddie Mac, and Ginnie Mae. Purchases of up to \$100 billion in GSE direct obligations under the program will be conducted with the FRB’s primary dealers through a series of competitive auctions and began during the week starting December 1, 2008. Purchases of up to \$500 billion in MBS will be conducted by asset managers selected via a competitive process with a goal of beginning these purchases before year-end. Purchases of both direct obligations and MBS are expected to take place over several quarters. The FRB stated that further information regarding the operational details of this program will be provided after consultation with market participants.

*Systemically Significant Failing Institutions Program Guidelines*

The Department of the Treasury issued guidelines for the Systemically Significant Failing Institutions Program (“SSFI”), which is a part of the TARP. Financial institutions will be considered for participation in the SSFI on a case-by-case basis. There is no deadline for participation in the SSFI. The Treasury highlighted four considerations for participation in the SSFI:

1. The extent to which the failure of an institution could threaten the viability of its creditors and counterparties because of their direct exposures to the institution;
2. The number and size of financial institutions that are seen by investors or counterparties as similarly situated to the failing institution, or that would otherwise be likely to experience indirect contagion effects from the failure of the institution;
3. Whether the institution is sufficiently important to the nation’s financial and economic system that a disorderly failure would, with a high probability, cause major disruptions to credit markets or payments and settlement systems, seriously destabilize key asset prices, significantly increase uncertainty or losses of confidence thereby materially weakening overall economic performance; or
4. The extent and probability of the institution’s ability to access alternative sources of capital and liquidity, whether from the private sector or other sources of government funds.

The Treasury will determine the form, terms, and conditions of any investment made pursuant to the SSFI on a case-by-case basis. The Treasury may invest in any financial instrument, including debt, equity, or warrants, that the Secretary of the Treasury determines to be a troubled asset, after consultation with the Chairman of the Board of the FRB and notice to Congress. The Treasury will require any institution participating in this program to provide the Treasury with warrants or alternative consideration, as necessary, to minimize the long-term costs and maximize the benefits to taxpayers in accordance with the EESA. The Treasury will also require any institution participating in the program to comply with the limitations on executive compensation applicable to SSFIs as set forth in Treasury Notice 2008-PSSFI. Please see the October 14, 2008 *Alert* and the October 27, 2008 *Alert* for additional discussion of the executive compensation limitations. In addition, the Treasury will consider other measures, including limitations on the institution’s expenditures or bonuses, or any corporate governance requirements, to protect the taxpayers’ interests or reduce ongoing risks to the financial system.

*Extension of FRB Liquidity Facilities*

The FRB has extended the Primary Dealer Credit Facility, the Asset-Backed Commercial Paper Money Market Fund Liquidity Facility, and the Term Securities Lending Facility through April 30, 2009. These facilities had previously been authorized through January 30, 2009. The extension of these facilities is consistent with the term authorized for several other liquidity-related facilities: the Commercial Paper Funding Facility, the Money Market Investor Funding Facility, and the temporary reciprocal currency arrangements (swap lines) with 14 other central banks. Please see the September 23, 2008 *Alert*, the September 30, 2008 *Alert*, the October 14, 2008 *Alert*, the October 21, 2008 *Alert*, the October 28, 2008 *Alert*, and the November 25, 2008 *Alert* for further discussion of these liquidity facilities.

Lynne B. Barr  
Gary A. Beller  
Kay E. Bondehagen  
Raymond P. Boulanger  
Agnes Bundy Scanlan  
Margaret B. Crockett  
Anna E. Dodson  
Eric R. Fischer  
Elizabeth Shea Fries  
Jackson B.R. Galloway  
John Hunt  
James J. Kelly  
Satish M. Kini  
Thomas J. LaFond  
Paul W. Lee  
Gregory J. Lyons  
Robin J. H. Maxwell  
William P. Mayer  
Philip H. Newman  
Sean P. O'Malley  
Christopher E. Palmer  
Byron C. Pavano  
Regina M. Pisa  
Mark S. Raffman  
Derek N. Steingarten  
William E. Stern  
Michael P. Whalen

To e-mail any of the above attorneys, use first initial of first name followed by last name followed by @goodwinprocter.com. For example, the e-mail address for Gregory J. Lyons would be glyons@goodwinprocter.com

## Other Items of Note

### ➤ IOSCO Launches Task Forces on Short Sales, Unregulated Financial Markets and Products and Unregulated Financial Entities

The International Organization of Securities Commissions Technical Committee launched three task forces to consider the following issues:

- **Short Sales** — this Task Force will work to eliminate gaps in various regulatory approaches to naked short selling, including delivery requirements and disclosure of short positions. It will also examine how to minimize adverse impacts on legitimate securities lending, hedging and other types of transactions that are critical to capital formation and to reducing market volatility. The Task Force will be chaired by the Securities and Futures Commission of Hong Kong.
- **Unregulated Financial Markets and Products** — this Task Force will examine ways to introduce greater transparency and oversight to unregulated market segments, such as OTC markets for derivatives and other structured financial products. It will be co-chaired by the Australian Securities and Investments Commission and the Autorité de Marché Financiers of France.
- **Unregulated Financial Entities** — this Task Force will examine issues surrounding unregulated entities such as hedge funds, including the development of recommended regulatory approaches to mitigate risks associated with their trading and traditional opacity. It will be chaired by the CONSOB of Italy and the Financial Services Authority of the United Kingdom.

The Task Forces will present their reports at the next Technical Committee meeting in February 2009 and to the next G-20 summit in spring 2009.

### ➤ SEC to Consider Action on Rating Agency Requirements

The SEC announced that it will hold an open meeting on Wednesday, December 3, 2008 at 10:00 a.m. to consider whether to adopt rule amendments that would impose additional requirements on nationally recognized statistical rating organizations (“NRSROs”) designed to address concerns about the integrity of credit rating procedures and methodologies. The SEC’s announcement also indicated it will consider “whether to propose and re-propose certain proposed rules relating to transparency and competition concerning NRSROs.” Earlier this year, the SEC proposed rules designed to address conflicts of interest for NRSROs, such as those posed by gifts to credit analysts from the issuers of securities being rated; the proposal also provided for public disclosure of performance statistics, ratings, ratings actions and information on rating methodologies, with a particular focus on structured products.

### ➤ Goodwin Procter Issues Client Alert Concerning Purchases and Sales of Distressed Debt in an Illiquid Credit Market

Goodwin Procter’s Financial Restructuring, Leveraged Finance and Private Equity Practice Areas jointly issued a Client Alert entitled “*Portfolio Company Debt: A New Investment Focus*”, that discusses issues concerning purchases of distressed debt by private equity firms in the current, illiquid credit market. The debt covered includes debt of non-affiliates under a “loan to own” strategy, and purchases of portfolio company debt under a “buy your own” strategy. A copy of the Client Alert is available at

<http://www.goodwinprocter.com/~media/93681949AC364178A90DBE79A7FB7A7B.ashx>.