

FINANCIAL SERVICES ALERT

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DEVELOPMENTS OF NOTE

Stimulus Act Modifies Executive Compensation Restrictions of Financial Institutions Participating in the TARP

The American Recovery and Reinvestment Act of 2009 (the "Stimulus Act") modifies and expands upon the executive compensation standards that were originally issued under the Troubled Assets Relief Program (the "TARP") and incorporates certain aspects of the standards announced by the Treasury earlier this month. The Stimulus Act amends Section 111 of the Emergency Economic Stabilization Act (the "EESA"), the source of the TARP standards, thus applying retroactively to all institutions that already participate in the TARP (e.g., financial institutions that received funds under the Capital Purchase Program). The restrictions of the EESA also apply to sponsors, including non-depository institutions, of

asset-backed securities which are pledged as collateral for the Term Asset-Backed Securities Loan Facility. The Stimulus Act now requires that TARP recipients adhere to the following:

Executive Compensation and Corporate Governance Standards. The new standards apply during the period in which there is any outstanding obligation to the federal government arising from financial assistance provided under the TARP (other than any period during which the federal government holds only warrants to purchase common stock of the TARP recipient). The new standards generally apply to “senior executive officers,” which are the top five most highly-compensated executives of a public company or the non-public company counterparts, except as otherwise specified. The new standards include:

Compensation Restrictions.

- A TARP recipient must limit compensation that excludes incentives for the senior executive officers to take unnecessary and excessive risks that threaten the value of the institution.
- A TARP recipient must put in place claw-back provisions to recover any bonus, retention award or incentive compensation paid to the senior executive officers and any of the next 20 most highly-compensated employees based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate.
- The senior executive officers and the next five most highly-compensated employees of each TARP recipient are prohibited from receiving any “golden parachute payment” upon severance from employment. For this purpose, the term “golden parachute payment” is now defined to mean any payment on account of a termination of employment, except for payments for services performed or benefits accrued. This means that no severance payments are permitted at all.
- A TARP recipient may not have compensation plans that encourage manipulation of the reported earnings of the TARP recipient in order to enhance the compensation of any of its employees.
- A TARP recipient is prohibited from paying or accruing any bonus, retention award or incentive compensation, other than the payment of restricted stock that (i) does not fully vest during the period in which there is any outstanding obligation arising from financial assistance provided under the TARP, (ii) has a value no greater than one-third of the employee’s annual compensation and (iii) is subject to any other terms and conditions the Secretary of the Treasury determines. This prohibition generally does not apply to any bonus payments required to be paid pursuant to a written employment contract executed on or before February 11, 2009. Moreover, this prohibition applies only to the following employees of TARP recipients:
 - The most highly-compensated employee of a TARP recipient receiving less than \$25 million under the TARP.
 - At least the top five most highly-compensated employees (or such higher number as the Secretary of the Treasury determines to be in the public interest) of a TARP recipient receiving at least \$25 million but less than \$250 million under the TARP.

- The senior executive officers and at least the ten next most highly-compensated employees (or such higher number as the Secretary of the Treasury determines to be in the public interest) of a TARP recipient receiving at least \$250 million and but less than \$500 million under the TARP.
- The senior executive officers and at least the 20 next most highly-compensated employees (or such higher number as the Secretary of the Treasury determines to be in the public interest) of a TARP recipient receiving \$500 million or more under the TARP.
- Under the Stimulus Act, TARP recipients continue to be subject to Section 162(m)(5) of the Internal Revenue Code, which generally limits the deductibility of compensation paid to the senior executive officers to \$500,000 per year.

Compliance Certification. The chief executive officer and chief financial officer of each TARP recipient must certify that such institution has strictly complied with all executive compensation restrictions. Public companies must file this certification with the Securities and Exchange Commission (the “SEC”), together with its annual filings, and private companies must file this certification with the Secretary of the Treasury.

Compensation Committee. Each TARP recipient must establish a compensation committee comprised solely of independent directors. The compensation committee must meet at least semiannually to discuss and evaluate compensation plans and assess any risk posed to the TARP recipient from such plans. In the case of privately-held TARP recipients receiving \$25 million or less in TARP assistance, such duties of the compensation committee may be undertaken by the board of directors.

Policy on Luxury Expenditures. The board of directors of any TARP recipient must adopt a company-wide policy regarding excessive or luxury expenditures, as determined by the Secretary of the Treasury, which may include those related to entertainment or events, office and facility renovations, aviation or other transportation services, or other activities or events that are not reasonable expenditures conducted in the normal course of the business operations.

Shareholder Advisory Vote on Executive Pay. During the period in which there is any outstanding obligation arising from financial assistance provided under the TARP, shareholders of a TARP recipient are entitled to approve the compensation of executives, as disclosed in the TARP recipient’s Compensation Discussion and Analysis and related compensation tables in the proxy statement. However, the shareholder resolution is non-binding and may not overrule the board of director’s decision or create any fiduciary duty by the board. In addition, the shareholder resolution does not restrict the ability of shareholders to make proposals for inclusion in the proxy related to executive compensation. The SEC is required to implement rules regarding this requirement within one year of the date of enactment.

Retroactive Review. The Stimulus Act provides that, in the case of a TARP recipient receiving assistance under the TARP prior to the enactment of the Stimulus Act, the Secretary of the Treasury is directed by Congress to review bonuses, retention awards, and other compensation of the senior executive officers and the next 20 most highly-compensated employees, in order to evaluate whether any such payments were

“inconsistent with the purposes” of the EESA or the TARP or were “otherwise contrary to the public interest.” In the event it is determined any of the payments should not have been made, the Secretary of the Treasury is directed by Congress to negotiate with the TARP recipient and the subject employee for reimbursement to the government of the compensation or bonus.

TARP Recipients May Withdraw Without Impediment

Many of the executive compensation restrictions discussed above are retroactive, which may cause TARP recipients to reconsider their participation in the TARP. The Stimulus Act allows the Secretary of the Treasury, in consultation with the appropriate Federal banking agency, to repay any assistance provided under the TARP without regard to whether the TARP recipient has replaced such funds from any other source or to any waiting period. This modifies the requirement in the Capital Purchase Program that for the three years following an investment, preferred shares may only be redeemed with a qualified equity offering of Tier 1 qualifying perpetual preferred stock or common stock which resulted in aggregate gross proceeds to the TARP recipient of at least 25% of the issue price of the senior preferred shares being redeemed. The Stimulus Act further provides that when a TARP recipient repays the assistance it received under the TARP, the Treasury will liquidate any warrants associated with such assistance at their current market price.

Treasury Announces New Restrictions on Executive Compensation

Prior to the enactment of the Stimulus Act, the Treasury issued guidelines on February 4, 2009, outlining new restrictions on executive compensation for certain institutions receiving financial assistance from the federal government. Although the Stimulus Act enacted several provisions that were similar to the guidelines issued by the Treasury, there were a few notable differences and exclusions:

- The Stimulus Act applies to all TARP recipients retroactively, while the Treasury’s guidelines largely apply to TARP recipients on a going-forward basis.
- The Treasury’s guidelines proposed a limitation on annual compensation payable to senior executives. Such executives would be prohibited from receiving total annual compensation in excess of \$500,000 with any excess to be paid in the form of long-term restricted stock with terms and conditions similar to those contained in the Stimulus Act. However, this compensation limit may be waived for most TARP recipients (other than those receiving exceptional assistance) by submitting compensation to a “say on pay” shareholder resolution.

The Treasury’s guidelines also proposed steps to undertake long-term executive regulatory reform regarding executive compensation, including (i) requiring compensation committees of all public companies to disclose the ways in which compensation arrangements encourage sound risk management and long-term value and growth for their companies and their shareholders, (ii) requiring all companies’ shareholders to pass non-binding shareholder resolutions approving the compensation structure, and (iii) having the Secretary of the Treasury host a conference on executive compensation arrangements.

U.S. Court of Appeals for the Seventh Circuit Affirms Dismissal of 401(k) Excessive Fee Litigation

The United States Court of Appeals for the Seventh Circuit (the “Seventh Circuit” or the “Court”) affirmed dismissal of a purported class action lawsuit that asserted ERISA breach of fiduciary duty claims on behalf of participants in the 401(k) plans offered by their employer (the “plan sponsor”). One of more than two dozen lawsuits that have been filed across the country challenging 401(k) plan fees, this was the first participant-filed suit decided when the United States District Court for the Western District of Wisconsin dismissed the complaint in June 2007. The complaint, filed in December 2006, asserted claims against the plan sponsor and two of the plans’ service providers, the plans’ trustee/recordkeeper and its investment adviser affiliate, which managed the mutual funds offered in the plans. Plaintiffs challenged as excessive the fees charged by the mutual funds offered in the plans, and in particular alleged a lack of disclosure regarding a revenue sharing arrangement under which the investment adviser shared a portion of the fees it received for managing the mutual funds offered in the plans with its affiliate, the trustee/recordkeeper.

In its February 12, 2009 decision, the Seventh Circuit agreed with the lower court that neither of the service provider defendants possessed relevant fiduciary authority such that it could be liable under ERISA for any alleged failure to disclose or imprudent choice of investment options. Specifically, the Court rejected plaintiffs’ assertion that each of the service provider defendants was a fiduciary of the plans because it played a role in the selection of investment options even though the plan sponsor retained the “final say” as to which investment options would be included in the plans. The Seventh Circuit also rejected the allegation that revenue sharing payments made by the investment adviser to the affiliated trustee/recordkeeper gave rise to fiduciary status, holding that fees collected from mutual fund assets and transferred to an affiliate were not plan assets subject to ERISA.

The Seventh Circuit also affirmed dismissal of the case against the plan sponsor, finding that it had breached no fiduciary duty based on the alleged failure to disclose revenue sharing between service providers, and that it had not acted imprudently in selecting funds for the plans. With respect to the challenged revenue sharing practices, the Court held that such practices violate no statute or regulation, and that plan participants were told about the funds’ total fees – the “critical figure” for determining plan expenses. (Recent Department of Labor regulatory initiatives are aimed at providing greater transparency of service provider compensation, including revenue sharing practices, to plan sponsors and participants. These initiatives, which include enhanced Form 5500, Schedule C reporting requirements and a proposed regulation under Section 408(b)(2) of ERISA relating to service provider fee disclosures, were discussed in the [January 1, 2008](#) and [July 29, 2008 Alerts](#). The new administration is reviewing the pending regulations.) Moreover, the Seventh Circuit held that to the extent that participants wanted detailed information on fund-level expenses, plan materials directed them to the funds’ public filings, which provided that information. With respect to the sponsor’s selection of investment options for the plans, the Seventh Circuit rejected the plaintiffs’ assertion that the sponsor acted imprudently in limiting its selection to the funds of one mutual fund complex, finding “no room for doubt” that the plans offered “a sufficient mix of investments,” and that in any event ERISA does not require “any particular mix of investment vehicles.” The Seventh Circuit also rejected plaintiffs’ claim that the funds in the plans charged excessively high fees, noting that mutual fund fees are set in a competitive market and that the plans offered funds with a wide range of fees. In rejecting plaintiffs’ claims as to both the array of

available options and the fees charged, the Court relied heavily on the fact that the plans' brokerage window option gave participants access to 2,500 additional funds that offered a wide range of fees.

Finally, the Seventh Circuit held that even if it had underestimated the fiduciary duties that ERISA imposes on the plan sponsor, the statute's safe harbor provision provides an affirmative defense to a claim for breach where certain conditions are met and plan participants exercised independent control over the assets in their plan accounts. Addressing the plaintiffs' contention that the district court had improperly considered this affirmative defense in dismissing the complaint, the Court found that the plaintiffs had anticipated the safe harbor defense in their complaint with extensive discussion as to whether the safe harbor's conditions were met, and as a consequence, the affirmative defense was "in play" and could properly form the basis for a dismissal. Finding no plausible allegation that the plans did not comply with the safe harbor provisions, the Seventh Circuit held that, particularly in light of the extensive options available to participants through the plans' brokerage window, any loss to participants "was attributable to their individual choice." Accordingly, the sponsor could avail itself of the safe harbor, providing an additional ground for dismissal. *Hecker v. Deere & Co.*, Nos. 07-3605 & 08-1224 (7th Cir. Feb. 12, 2009).

DOL Final Regulation and Exemption for Investment Advice is Delayed

The Department of Labor (the "DOL") recently published a final regulation under Sections 408(b)(14) and 408(g) of the Employee Retirement Income Security Act of 1974, addressing the provision of investment advice to participants in Section 401(k) plans and individual retirement account holders (the "Investment Advice Regulation"). (The Investment Advice Regulation was originally proposed in 2008 and such proposal was described in the [September 2, 2008 Alert](#).) The Investment Advice Regulation was scheduled to be effective on March 23, 2009; however, the DOL has issued a notice of postponement of the effective date in accordance with a directive issued by the new administration. The notice of postponement reopens the comment period on the Investment Advice Regulation until March 6, 2009 and delays the effective date until May 22, 2009. It is expected that there could be significant changes made to the Investment Advice Regulation during this period.

Reminder: IRS Reporting Obligations for Businesses and Individuals Regarding Foreign Bank and Financial Accounts

As a reminder, individuals and businesses have an obligation to report to the Internal Revenue Service ("IRS") regarding their interests in foreign bank and financial accounts, including bank, securities, securities derivative, prepaid credit or debit card, and other accounts maintained abroad. Individuals must disclose on Schedule B of their federal income tax returns if, at any point in 2008, they had a financial interest in or signature or other authority over one or more financial accounts in a foreign country with an aggregate value of over \$10,000. In addition, all U.S. persons (both individuals and businesses) that had such an interest must file a "Foreign Bank Account Report," or "FBAR," on Form TD F 90.22-1 with the IRS by June 30, 2009. Form TD F 90.22-1 is available on the websites of both the IRS and the Financial Crimes Enforcement Network ("FinCEN").

As a general rule, employees and officers of a firm that has foreign financial accounts are not exempted from reporting merely because the firm has made a necessary FBAR filing.

Indeed, employees and officers who sign on their firm's foreign accounts may have their own FBAR reporting obligation. There are only limited exceptions to this rule. For example, officers and employees of certain banks and of U.S. corporations with publicly traded shares in the United States or with assets exceeding \$10 million and more than 500 shareholders may qualify for an FBAR filing exception.

Firms will need to consider carefully their FBAR obligations because a firm's foreign bank accounts may result in reporting obligations (and consequences for failing to meet those obligations) not only for the firm but also for the firm's employees. Moreover, firms may wish to consider the April 15 filing deadline for individual tax returns in determining when to assess their FBAR reporting obligations.

Comptroller Criticizes Congressional Oversight Fund Report on Regulatory Reform on Discussion of Effects of Federal Preemption

In a defense of consumer protection standards applicable to national banks, Comptroller of the Currency John C. Dugan wrote a letter to Elizabeth Warren, Chair of the Congressional Oversight Panel (the "Panel") stating that the Panel's "Special Report on Regulatory Reform" (the "Report") was incomplete and gave inaccurate impressions in its discussion of federal preemption of state consumer protection laws in the context of national banks.

Comptroller Dugan took issue with the Report's suggestion that the doctrine of federal preemption results in state regulation producing more robust consumer protection standards than are applicable to national banks. Comptroller Dugan stated, and provided supporting data, that most toxic subprime mortgages were originated by companies subject only to state regulation. He also stressed that state-regulated nonbank mortgage brokers and mortgage lenders were the "market leaders in the market for subprime loans especially in their most aggressive form." In addition, Comptroller Dugan criticized the Report for failing to refer to or consider "the many, many federal consumer protection laws, rules and supervisory guidance applicable to national banks."

OTHER ITEMS OF NOTE

Goodwin Procter Issues Client Alert Discussing Modifications to Massachusetts Data Security Regulations Including Postponed Compliance Date

Goodwin Procter issued a Client Alert discussing recent revisions to the new Massachusetts data security regulations on the Standards for the Protection of Personal Information of Residents of the Commonwealth (201 CMR 17.00), including a postponed compliance date of January 1, 2010. The new regulations were the subject of [September 29, 2008](#) and [November 17, 2008](#) Goodwin Procter Client Alerts. The Client Alert discussing the recent revisions is available in the publications section of the Goodwin Procter website at <http://www.goodwinprocter.com/~media/5543AE47B3664F5191F7396B9A741FEC.ashx>.

SEC Issues Adopting Release for Rules Requiring Mutual Funds to Provide Risk/Return Summary Information in Interactive Data Format

The SEC published the formal release for rules adopted at its December 17, 2008 open meeting that will require registered open-end investment companies ("funds") to provide

the risk/return summary information in their prospectuses as an exhibit in interactive data format to registration statements and to definitive filings under Rule 497(c) and (e) under the Securities Act of 1933 that contain risk/return summary information that differs from that in the registration statement. The risk/return summary in fund prospectuses provides information about a fund's investment objectives and strategies, costs, risks, and past performance. The new requirements, which do not alter the risk/return summary disclosure requirements for fund prospectuses, will supplement risk/return summary information provided in traditional electronic format. The requirements for registration statements will apply beginning with initial statements and post-effective amendments that are annual updates to effective registration statements and that become effective after January 1, 2011. The requirement to submit a risk/return summary exhibit in interactive data format with any form of prospectus filed pursuant to Rule 497(c) or (e) will not apply until a fund has first submitted an exhibit to its registration statement with risk/return summary information in interactive data format. The final release is available on the SEC website at <http://www.sec.gov/rules/final/2009/33-9006.pdf>. A more detailed discussion of the new requirements will appear in a future edition of the *Alert*.

SEC Publishes Release for Final Rules Regarding Use of Interactive Data in Financial Statements for Operating Companies

The SEC published a formal release adopting rules that will require public companies and foreign private issuers that prepare their financial statements in accordance with U.S. generally accepted accounting principles (U.S. GAAP), and foreign private issuers that prepare their financial statements using International Financial Reporting Standards to provide their financial statements to the SEC and on their corporate websites in interactive data format. (The new requirements do not apply to investment companies that are registered under the Investment Company Act of 1940, business development companies, and other entities that report under the Securities Exchange Act of 1934 and prepare their financial statements in accordance with Article 6 of Regulation S-X. The new interactive data requirements will apply to (a) registration statements under the Securities Act of 1933, (b) quarterly and annual reports, (c) transition reports, and (d) reports on Forms 8-K or 6-K that contain specified financial statements. Financial statement disclosure in interactive data format will be submitted as an exhibit to the applicable SEC filings and will supplement, but not replace or change, disclosure using the traditional formats for electronic filings with the SEC. The requirements are being phased in with domestic and foreign large accelerated filers using U.S. GAAP that have a public float above \$5 billion being the first required to comply with the new requirements starting with their first quarterly report for fiscal periods ending on or after June 15, 2009. The adopting release is available on the SEC website at <http://www.sec.gov/rules/final/2009/33-9002.pdf>.

SEC Extends Comment Period for Concept Release on the Use of International Financial Reporting Standards by U.S. Issuers

The SEC extended the period for public comment on its concept release on the use of International Financial Reporting Standards ("IFRS") by U.S. issuers, including investment companies, in preparing their financial statements. The original comment scheduled to end on February 19, 2009 has been extended until Monday, April 20, 2009.

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SEC Publishes Releases for Final Rules and Proposed Rulemaking Affecting NRSROs

The SEC published formal releases for final and proposed rules related to the regulation of the credit rating agencies that register with it as Nationally Recognized Securities Rating Organizations (“NRSROs”), as approved at its December 3, 2008 meeting. The final rules address conflicts of interest in the rating process and NRSROs’ reporting and disclosure obligations, particularly with respect to ratings for structured finance products. The proposed rules would make additional changes to the SEC’s NRSRO rules and Regulation FD affecting other disclosures related to the credit rating process. (For additional detail on the adopted and proposed rule changes, see the [December 9, 2008 Alert](#).) The adopting release for the final rules is available on the SEC website at <http://www.sec.gov/rules/final/2009/34-59342.pdf>. The release proposing additional rule changes is available on the SEC website at <http://www.sec.gov/rules/proposed/2009/34-59343.pdf>.

FDIC Extends Temporary Liquidity Guarantee Program

The FDIC extended the Temporary Liquidity Guarantee Program (“TLGP”) through October 2009. Though this extension allows banking organizations participating in the Debt Guarantee Program under TLGP to issue guarantee for an additional four months, the FDIC will assess an additional premium on guaranteed debt issued between July 1, 2009 and October 31, 2009.

SPECIAL ANNOUNCEMENT

Goodwin Procter partner Sean O'Malley, whose practice focuses upon broker-dealer regulation, will be a speaker at the *Introduction to European Regulation* course presented by FINRA on March 16 in New York. The other speakers include Dr. Markus Escher who heads the banking team at GSK Stockmann & Kollegen a leading German law firm and Rob Moulton who heads up the Nabarro Financial Services Regulation Group. This course covers European regulation relevant to U.S. securities firms operating into the European Union (E.U.) or interacting with counterparties in the E.U., and serves as an interactive forum to better understand legal and regulatory applications. The course looks at the fundamental issues of conducting business on a cross-border basis in Europe, and uses clear, practical examples of how today’s firms manage the interaction between rules and principles applicable to U.S. parent firms, and those rules governing securities business in the U.K. and Europe.

For more information, please [click here](#). If you wish to attend, please either call 202-728-8849 or use the Fax registration form on the webpage. Please be sure to identify yourself as a client or friend of Goodwin Procter and you will be offered the FINRA member rate for the program.