

# Financial Services Alert

Goodwin Procter LLP, a firm of 700 lawyers, has one of the largest financial services practices in the United States.

## New Subscribers, Past Issues and Background Material:

If you would like anyone else to receive issues of the Financial Services Alert, would like to receive any past issues, or would like the background materials for any of the matters discussed in this issue, please contact **Greg Lyons, Eric Fischer, Elizabeth Shea Fries** or **Jackson Galloway** at 617.570.1000 or at the e-mail addresses referenced at the end of this newsletter.

## Alert on the Web:

Back issues of the *Alert* are available at [www.goodwinprocter.com/Publications/Financial%20services%20Alerts.aspx](http://www.goodwinprocter.com/Publications/Financial%20services%20Alerts.aspx)

## Disclaimer:

This publication, which may be considered advertising under the ethical rules of certain jurisdictions, is provided with the understanding that it does not constitute the rendering of legal advice or other professional advice by Goodwin Procter LLP or its attorneys.

©2007 Goodwin Procter LLP  
All rights reserved.

## *In this issue:*

### *Developments of Note*

1. FDIC Issues Cease and Desist Order against California ILC Targeting Weak Subprime Lending and Commercial Real Estate Lending Practices
2. Federal District Court Permanently Enjoins Enforcement of Illinois Law Generally Prohibiting the Deposit of State Moneys or Investment by State and Municipal Pension Plans in Entities Having Certain Connections with Sudan
3. FRB, OCC and FDIC Speak on Basel II Status and Issues
4. OTS Issues Gift Card Guidance
5. SEC Announces Regional CCO Outreach Seminars for Fund and Adviser Chief Compliance Officers
6. SEC Staff Provides No-Action Relief from Advisers Act Personal Trading Reporting Requirements to U.K. Based Adviser for Certain U.K. Securities

### *Other Item of Note*

7. Goodwin Procter Adds Website Feature Covering Basel Proposal Developments

## *Developments of Note*

### ➤ **FDIC Issues Cease and Desist Order against California ILC Targeting Weak Subprime Lending and Commercial Real Estate Lending Practices**

The FDIC issued a cease and desist order (the “Order”) against a California industrial loan company (“ILC”) and its parent company (collectively, the “Bank”). The Order requires the Bank to take steps to address capital, liquidity and management weaknesses and to implement effective risk management policies and procedures with respect to the Bank’s subprime residential mortgage lending and commercial real estate (“CRE”) lending operations. The Order requires the Bank, among other things, to: (1) adopt a five-year strategic plan that covers its subprime and CRE lending; (2) underwrite future subprime loans using an analysis of the borrower’s ability to repay at the fully indexed rate (rather than a “teaser” interest rate); (3) provide customers with clear disclosures about the benefits and risks of specific loan products; (4) restructure loans in distress in a manner consistent with their marketability and sound underwriting practices; (5) comply with all consumer protection laws; and (6) reduce dependence on mortgage brokers. The issuance of the Order is an indication of the bank regulatory agencies’ growing concern with the risks to financial institutions associated with subprime lending programs (*see* the March 6, 2007 *Alert*). The FDIC stated that the fact that the Order was issued against an ILC (rather than against some other type of financial institution) was incidental.

### ➤ **Federal District Court Permanently Enjoins Enforcement of Illinois Law Generally Prohibiting the Deposit of State Moneys or Investment by State and Municipal Pension Plans in Entities Having Certain Connections with Sudan**

The U.S. District Court for the Northern District of Illinois (the “Court”) permanently enjoined the enforcement of the Illinois Act to End Atrocities and Terrorism in the Sudan (the “Act”) on the grounds that it (a) is preempted by federal law addressing Sudan, (b) impermissibly interferes with the federal government’s authority over foreign affairs and (c) violates the Foreign Commerce Clause of the U.S. Constitution, which gives Congress the authority to regulate foreign commerce. The Act imposes

various restrictions on the deposit of state funds in financial institutions whose customers have certain types of connections with Sudan and on the investment by pension funds formed under the Illinois pension code, which include both state and municipal pension plans, in certain Sudan-connected entities (“forbidden entities”). The Act also requires affected pension plans to divest themselves of existing investments within eighteen months of the Act’s January 27, 2006 effective date. Since that date, the state has withdrawn \$275 million from banks that have not met the Act’s requirements. The plaintiffs, which consisted of the National Foreign Trade Council, eight Illinois municipal pension funds and eight beneficiaries of public pension funds, brought the action seeking a permanent injunction on various constitutional grounds, which are discussed below. The plaintiffs also argued that the National Bank Act preempted the Act, but the Court did not reach this issue having found for the plaintiffs on other grounds, as discussed below.

*Preemption.* In examining federal law directed at Sudan, the Court noted inconsistencies with the Act, principally in terms of differences in the scope of their respective restrictions and because federal law grants considerable discretion to the President in terms of courses of action to be pursued and waivers of statutory prohibitions and restrictions. On the basis of this analysis, the Court concluded that the portion of the Act affecting the deposit of state moneys was enough of an obstacle to the objectives of federal law *vis-à-vis* Sudan that federal law preempted that portion of the Act. As for the portion of the Act affecting pension plans, the Court found that the potential effect of divestment required under the Act was too attenuated and that the Court had not been presented with sufficient evidence to conclude that pension funds’ inability to purchase securities of forbidden entities would be in any way likely to affect the entities’ willingness to do business in Sudan.

*Foreign Affairs Power.* Citing the differences between federal law and the Act and the \$275 million of state bank deposits already withdrawn as a result of the Act, the Court concluded that the portion of the Act affecting bank deposits of state moneys was an unconstitutional intrusion on the federal government’s exclusive authority to conduct foreign affairs. The Court reached the opposite conclusion with respect to the portions of the Act affecting the state’s pension code because it found the evidence indicated only a hypothetical effect on the federal government’s conduct of foreign affairs with the Sudan. In particular, the Court noted that it had not been presented with any evidence regarding equity or debt offerings contemplated by companies that are ineligible pension plan investments under the Act, the potential market demand for those offerings and the share of that market demand attributable to public Illinois pension plans. The Court found that the evidence regarding the Act’s ban on investment in securities of forbidden entities traded in the secondary market was similarly speculative regarding the effect of that measure on forbidden entities’ conduct with respect to Sudan and thus on the federal government’s conduct of foreign affairs with respect to that country.

*Foreign Commerce Clause.* The Court found that the pension plan limitations of the Act as they applied to municipal (as opposed to state) pension plans ran afoul of the Constitution’s Foreign Commerce Clause, which gives Congress the power to regulate commerce with foreign nations. In doing so, the Court considered the possibility that the market participant doctrine might provide an exception in the context of the Foreign Commerce Clause similar to that recognized in the Constitution’s Interstate Commerce Clause, which gives Congress the power to regulate commerce among the states. The market participant doctrine allows state activities that would otherwise run afoul of the Interstate Commerce Clause when the state is acting as a market participant, *e.g.*, the state is acting for its own account in a commercial transaction. Noting a conflict among other federal circuit courts of appeal on this point, the Court indicated that it was not resolving the issue of whether or not the market participant doctrine applied to the Foreign Commerce Clause. The Court observed that even if the exception did apply, the portion of the Act affecting the state’s pension code applied not only to state-controlled pension plans, but also to those controlled by municipal entities. The Court had previously held that the market participant doctrine did not apply to a state when the market participants were its local political subdivisions and the projects at issue were not financed or administered by the state. The Court found that the municipal pension plans in this action were similarly situated in that they were administered by locally-appointed boards and funded by employee contributions and contributions by municipalities. The Court concluded that Illinois could not be considered a market

participant when it proscribes the investment choices of municipal pension funds. The Court noted that there may be other reasons why the state does not function as a market participant in restricting pension plan holdings. The Court also stated that it expressed no opinion on the constitutionality of a more narrow amendment to the pension code or whether the state is a market participant with respect to state funded pensions.

*Severability.* Because the Act's amendment to the pension code is a single provision that applies to any pension plan established under the pension code, the Court found that it could not sever the unconstitutional portion of the statute. Because it could not rewrite the statute, the Court, therefore, found the Act's amendment to the pension code unconstitutional in its entirety (regardless of the type of pension plan affected).

### ➤ **FRB, OCC and FDIC Speak on Basel II Status and Issues**

At a conference of the Global Association of Risk Professionals at the end of February, senior representatives of the FRB, OCC and FDIC spoke on Basel II status and issues. The speeches highlighted the significant issues and differences that the regulators continue to address as they seek to implement a Basel II system by 2008.

As to the FRB, Governor Bies first emphasized the inadequacy of Basel I, and how Basel II should establish a greater correlation between regulatory capital and day-to-day risk-focused supervision of banks. She also discussed the supervisory guidance addressing Pillars 1, 2, and 3 of Basel II that the agencies have published in February (discussed in the February 20, 2007 and February 27, 2007 Alerts), stating that rather than prescribing a particular approach, "the guidance identifies an acceptable range of practices for banks." She further discussed how the agencies recognize the banks' burdens and frustrations in trying to implement Basel II from constantly evolving proposed rules, but stated that the agencies remain open to considering the full set of possibilities for Basel II, including the Standardized Approach. In evaluating whether the Standardized Approach was a viable option, Governor Bies stated that the agencies would have to review several factors, including whether it would accommodate the risks of large banks, whether the time needed to develop a Standardized Approach would unduly delay implementation of the rules, and whether the marketplace would find such an option acceptable. As to competitive issues, Governor Bies stated that safety and soundness of the US banking system is the "first criterion by which these regulatory capital proposals should be judged," but did recognize that there were differences between the US and foreign proposals and that it was "worthwhile to minimize them whenever possible." Still, rather than indicating regulatory capital requirements may decrease, she indicated that banks may need to evaluate whether their current capital was appropriate as more risk-sensitive systems come into place.

FDIC Chairman Bair expressed greater concern about reductions in regulatory capital, stating that from the outset Basel II was "about improvements in risk management and not about dramatic reductions in capital requirements." She stated that the capital reductions indicated by the quantitative impact studies (the "QIS") would be "unacceptable" if they occurred once the system is effective, and disagreed that Pillar 2 of Basel (Supervisory Oversight) would provide adequate safeguards if Pillar 1 allowed general capital levels to drop significantly. Ms. Bair noted that she was aware that US banks had concerns about international competition, but "a race to the bottom in bank capital standards would be a profoundly negative development for the future stability and health of the global financial system." Ms. Bair further stated that, to reduce the costs and burdens expressed by the large banks, she thought that making a Standardized Approach available might be acceptable.

As to the OCC, among other things, Comptroller of the Currency John Dugan concurred that the reductions indicated by the QIS would be unacceptable given what the regulators understand of the risk profile of the banks involved. However, if the regulators "can gain enough comfort that institutions are assessing and managing risk well, that they have a firm grasp on their own capital adequacy, with trustworthy internal processes that give great confidence that risks have been identified, assessed, and

managed – that risk is indeed low – then the case for lower capital to match that lower risk is significantly strengthened.”

### ➤ OTS Issues Gift Card Guidance

The OTS published guidance containing supervisory expectations for gift card programs (the “Guidance”). The Guidance covers account administration, marketing and consumer protection practices, as well as legal compliance and safety and soundness concerns. In particular, the Guidance focuses on OTS expectations that a thrift will provide adequate disclosures to its customers concerning the terms, fees, basic features, conditions and limitations of gift cards. The Guidance provides examples of disclosures that should be provided, including information regarding where the card can be used, applicable fees, how balances can be checked, policies for lost cards and expiration dates. The Guidance states that expiration dates should be at least 12 months from the date of purchase. In its release, the OTS noted that approximately 20 percent of thrifts offer some form of gift card program.

### ➤ SEC Announces Regional CCO Outreach Seminars for Fund and Adviser Chief Compliance Officers

The SEC staff announced the dates and locations of its annual regional seminars and posted them on the SEC’s website. The regional seminars are part of the CCO Outreach Program sponsored by the SEC’s Office of Compliance Inspections and Examination and Division of Investment Management. The program which is designed to enhance communication and coordination between registered fund and adviser chief compliance officers (“CCOs”) and the SEC staff. Registration for the regional seminars, which have limited seating, is open on a first come first served basis, with priority going to fund and adviser CCOs.

The topics to be addressed at the regional seminars include the following:

- the examination and risk assessment process;
- books and records and disclosures and filings;
- brokerage arrangements, best execution, trade allocation, and soft dollars;
- portfolio management; and
- marketing, performance, advertising and distribution.

SEC examiners will discuss the risk identification and assessment process they use in examinations, and how the risk identification process can help fund an adviser compliance programs. The seminars will also address the information and documents requested during SEC examinations; various analyses and forensic tests that may be performed using this information; frequent examination findings; and factors to consider when establishing compliance controls.

### ➤ SEC Staff Provides No-Action Relief from Advisers Act Personal Trading Reporting Requirements to U.K. Based Adviser for Certain U.K. Securities

The staff of the SEC’s Division of Investment Management (the “staff”) granted no-action relief to a registered adviser based in the U.K from the reporting and recordkeeping requirements of Section 204A of the Investment Advisers Act of 1940, as amended (the “Advisers Act”), and related Rule 204A-1, which govern reporting of personal securities transactions by certain personnel of registered advisers, and Rule 204-2(a)(13) under the Advisers Act, which governs related recordkeeping. The staff granted relief to the London-based adviser (the “Adviser”), whose only U.S. client is a registered open-end fund, with respect to personnel who may not direct, or influence a decision to direct, the execution of portfolio transactions by the U.S. mutual fund to broker-dealers and other intermediaries. The relief exempts those persons from having to report to the Adviser their personal transactions in certain U.K. securities that meet specified conditions. The Adviser argued that the features of the U.K. securities as

Lynne B. Barr  
Gary A. Beller  
Kay E. Bondehagen  
Raymond P. Boulanger  
Agnes Bundy Scanlan  
Margaret B. Crockett  
Eric R. Fischer  
Martin J. Flynn  
Elizabeth Shea Fries  
Jackson B.R. Galloway  
Geoffrey R.T. Kenyon  
Satish M. Kini  
Thomas J. LaFond  
Paul W. Lee  
Gregory J. Lyons  
Robin J. H. Maxwell  
William P. Mayer  
Philip H. Newman  
Anthony R. G. Nolan  
Christopher E. Palmer  
Regina M. Pisa  
Mark S. Raffman  
Victoria E. Schonfeld  
William E. Stern  
Michael P. Whalen  
Meryl E. Wiener

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

modified by the conditions of the no-action relief were analogous to the relevant characteristics of certain U.S. securities excluded from reporting and recordkeeping under the terms of the aforementioned rules, *i.e.*, direct obligations of the U.S. government, registered open-end funds not otherwise required to be reported under the aforementioned rules (“non-reportable funds”) and unit investment trusts that invest exclusively in the non-reportable funds. The staff also granted relief to exclude the specified U.K. securities from corresponding personal securities transaction reporting requirements of Rule 17j-1 under the Investment Company act of 1940, as amended, which mandates personal securities transaction reporting by certain insiders of registered funds.

## *Other Item of Note*

### ➤ **Goodwin Procter Adds Website Feature Covering Basel Proposal Developments**

Goodwin Procter is pleased to announce a new feature on our website, dedicated to the Basel Committee capital proposals. The site will be updated as new Basel developments emerge, with an option for viewers to receive automatic e-mail updates as well. Click to <http://www.goodwinprocter.com/basel.html> for more information.