

# Financial Services Alert

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## *In this issue:*

### *Developments of Note*

1. NYBD Evaluates Risk Capital Impact of Basel II Standardized Approach
2. Banking Agencies Publish Supplemental Guidance on Basel II—Supervisory Review Process
3. SEC Staff Provides Guidance Regarding the Use of Hedge Clauses in Investment Advisory Agreements
4. NASD Issues Notice to Members Regarding Oversight of Recommendations Made by Registered Representatives That Have Just Changed Firms

## *Developments of Note*

### ➤ NYBD Evaluates Risk Capital Impact of Basel II Standardized Approach

Katherine Wyatt, a member of the New York State Banking Department (the “NYBD”), evaluated the risk capital affect (the “Study”) of implementation of the Standardized Approach provided by the International Basel II Accord (the “Standardized Approach”). As has been discussed in previous issues of the *Alert*, including the summary of the Basel II Conference co-hosted by Goodwin Procter on December 13, 2006, many of the so-called “core” US Basel II banks, which currently are required to implement the Advanced Approach provided by Basel II (the “Advanced Approach”), have been urging US federal bank regulators to also make the Standardized Approach available to them.

The Study first summarizes the Standardized Approach. Generally, the Standardized Approach uses a greater number of risk weight buckets than the current approach, and also relies to a much greater extent on external risk weightings. The Study cites as key differences between the Standardized Approach and the current approach that the Standardized Approach: (1) weights all residential mortgage loans at 35% (rather than 50% on first mortgage loans, with the current approach), (2) applies capital charges to shorter than 1 year commitments that are not unconditionally cancelable by the bank, as well as to reverse repurchase agreements (“reverse repos”) (rather than just repurchase agreements (“repos”) under the current approach); and (3) has an express charge for operational risk.

Applying the Standardized Approach to the NY headquartered banks, the Study generally showed a 5% reduction in required risk-based capital for credit risk, offset by a 10% operational risk charge, for a net estimated 5% increase in required regulatory capital. More specifically, the Study showed a material drop in required risk capital for small business, individual and residential lending, an increase in such capital for repos, reverse repos, derivatives, unused commitments, and past due and nonaccrual loans. However, using less conservative assumptions as to what is considered a “residential loan” subject to the 35% risk weight, the Study estimated an aggregate 1.72% drop in required risk capital (even including an operational risk component).

The Study also summarized the differenced between the Standardized Approach, the Advanced Approach and US Basel IA. While the Standardized Approach and the Advanced Approach generally have the same approaches to credit risk mitigation, Basel IA does not have the same flexibility. However, Basel IA does not have a capital requirement for reverse repos. Moreover, Basel IA has a 10% credit conversion factor (“CCF”) for unused short term commitments, rather than a 20% CCF for the Standardized Approach. Finally, whereas the Standardized and Advanced Approaches treat first

and subsequent liens on residential property similarly, Basel IA uses a loan to value approach and also treats junior liens differently than more senior liens.

Finally, as to competitive impacts, the Study estimates that banks that chose the Advanced Approach would have lower risk capital requirements than those that chose the Standardized Approach, albeit with a greater expenditure of resources. Generally, if banks had a choice of the Standardized Approach and Basel IA, they would generally choose Basel IA because of its easier implementation and absence of an operational risk requirement. t

### ➤ **Banking Agencies Publish Supplemental Guidance on Basel II—Supervisory Review Process**

The four federal banking agencies published extensive proposed supervisory guidance documents (the “Supervisory Guidance”) meant to supplement the US Basel II Advanced Capital Adequacy Framework (the “Advanced Framework”) notice of proposed rulemaking issued on September 25, 2006. The Supervisory Guidance covers three distinct areas: (1) internal risk based systems for credit risk; (2) the advanced management approach to operational risk; and (3) the supervisory review process for the Advanced Process (so-called “Pillar 2” of the “Advanced Approach”). This article focuses on the third component, and the first two components will be addressed in future issues of the *Alert*. Comments on all aspects of the proposal are due within 90 days of its publication in the *Federal Register*.

As to the Pillar 2 guidance, the proposal separates the guidance into 3 subparts: (1) comprehensive supervisory assessment of capital adequacy; (2) compliance with regulatory capital requirements; and (3) internal capital adequacy assessment process (“ICAAP”). The proposal makes clear that it does not supersede the US Prompt Corrective Action Rules or the otherwise applicable risk management practices. Rather, it is intended to help bank regulators intervene when necessary to protect an institution’s capital safety and soundness.

As to the first subpart (comprehensive supervisory assessment), the proposal first reiterates that, consistent with historical practice, regulators expect banks to hold capital above their minimum capital requirements, commensurate with their overall risk profile. The relevant federal bank regulator has the authority to evaluate whether a bank’s capital is adequate as circumstances change, and to take action if it determines capital to be inadequate.

As to the second component (regulatory capital compliance), the proposal highlights that regulators must ensure that banks are meeting the qualification requirements that the Advanced Approach imposes for the calculation of regulatory capital. Banks must demonstrate that they meet this qualification requirements not just initially, but also on an ongoing basis. If a bank fails to satisfy the ongoing standards, it would be required to develop a satisfactory plan explaining how it would return to compliance. The proposal also makes clear that banks using the Advanced Approach must satisfy the qualification requirements at the bank level, as well as at the consolidated entity level.

The proposal focuses most on the third subpart, ICAAP. The proposal emphasizes that, in addition to calculation of regulatory capital, a bank must calculate ICAAP, which is the bank’s assessment of its overall capital adequacy. The proposal further details that the three main objectives of a sound ICAAP policy are to: (1) identify and measure material risks; (2) establish internal adequacy goals that directly relate to that risk; and (3) ensure the integrity of the foregoing assessments on an ongoing basis. As to its rigorousness, the proposal declares that “the ICAAP will likely go beyond the restrictive or simplifying assumptions in regulatory requirements.”

As to the first objective, the proposal states that the bank must identify all material risks, including credit risk, market risk, operational risk, interest rate risk, liquidity risk, and perhaps also reputational risk, strategic risk, and country risk. If a bank uses risk mitigation techniques, it should be able to specify how each of those techniques apply to each risk. In assessing these risks, a quantitative approach should be the foundation of the bank’s framework, but qualitative methods are appropriate

when risks cannot be reliably measured quantitatively. These risks should be measured across the entire bank, and include the possible effects of concentration and diversification.

As to the second objective, the proposal provides that the goal is to set and assess capital adequacy goals in relation to all material risks, with capital reflecting not only measured risk, but also uncertainty. In assessing adequate capital, a bank should consider internal factors and assumptions, external conditions, and also ensure capital is held not with respect only to a point in time, but also over time to account for periodic changes. The bank should clearly state how it defines “capital” for purposes of ICAAP, and also the time horizon over which the bank is assessing capital adequacy.

Finally, as to the third subpart, the proposal also highlights that a bank’s determination of adequate capital also must be subject to proper oversight and controls. Adequate internal controls and documentation should exist to “ensure transparency, objectivity, and consistency with ICAAP.” The controls and documentations should be enhanced and refined over time as learning and experience warrant. The system created should be subject to validation policies and procedures. Moreover, while the primary use of an ICAAP is to provide an assessment of internal capital adequacy, management should be able to demonstrate that it uses the data in business

### ➤ **SEC Staff Provides Guidance Regarding the Use of Hedge Clauses in Investment Advisory Agreements**

In response to a registered adviser’s request for no-action relief regarding standard hedge clause and non-waiver disclosure used in the adviser’s agreements with certain types of clients, the staff of the SEC’s Division of Investment Management (the “staff”) provided general guidance on the use of hedge clauses in advisory contracts in compliance with the anti-fraud prohibitions of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, as amended (the “Advisers Act”). In simple terms, the adviser’s standard hedge clause provides that the client will indemnify the adviser against losses arising out of the performance of the advisory agreement except to the extent the losses arise out of the adviser’s gross negligence, recklessness or willful misconduct. The adviser’s accompanying standard non-waiver disclosure states that, in spite of the hedge clause, the client retains legal rights against the adviser under the federal securities laws and other laws whose protections are non-waivable. The adviser argued that the types of clients in whose advisory contracts these clauses would be used are sufficiently sophisticated in legal matters to understand the clauses’ effect and have sufficient bargaining power to protect their interests appropriately, or would be represented in the negotiation of such contracts by a party with sufficient sophistication and bargaining power. These clients include large institutional investors, such as institutions meeting the definition of “qualified institutional buyer” under Rule 144A pursuant to the Securities Act of 1933, as amended, and participants in wrap programs sponsored by advisers registered under the Advisers Act. In the latter case, the adviser noted that the client would be represented by an entity that has a separate responsibility to negotiate an advisory agreement that represents that client’s best interests.

In its response, the staff observed that the use of a hedge clause or other exculpatory provision that is likely to lead an advisory client to believe that the client has waived rights of action against the adviser under federal or state law that, in fact, cannot be waived, may violate the anti-fraud prohibitions of Sections 206(1) and 206(2) of the Advisers Act. The response also acknowledges that the staff has previously taken the position that hedge clauses that purport to limit an investment adviser’s liability to acts involving gross negligence or willful malfeasance are likely to mislead a client “unsophisticated in the law” into believing that he or she has waived non-waivable rights, even if non-waiver disclosure accompanies the hedge clause.

The staff declined to provide the no-action assurances requested by the adviser regarding its use of hedge clauses and non-waiver disclosure with particular categories of clients because to do so would require an analysis of all the surrounding facts and circumstances of each individual client situation. The staff went on to state that, as a matter of policy, it will not provide no-action or interpretive assurances under Sections 206(1) or 206(2) of the Advisers Act regarding an investment adviser’s use

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of any particular hedge clause with its clients. The staff did, however, indicate that it did not regard the type of hedge clause and non-waiver disclosure described in the request for relief as *per se* violative of Sections 206(1) and 206(2) of the Advisers Act and articulated various factors it would consider relevant to the determination of whether the use of a hedge clause in a particular client contract violates the anti-fraud provisions of the Advisers Act, as follows: (a) the form and content of the hedge clause (*e.g.*, its accuracy), (b) any oral or written communications between the adviser and the client about the hedge clause and (c) the particular circumstances of the client, such as whether the client is sophisticated in legal matters. In this context, the staff noted that a hedge clause may be misleading in its overall effect even though it might be argued that when narrowly and literally read, no single statement of material fact is false. The staff also observed that an adviser has an affirmative duty to explain a hedge clause if the adviser believes or has reason to believe that a particular client, in light of his or her unique circumstances, would be likely to be misled by the hedge clause. In the case of a client that is not sophisticated in legal matters, the staff indicated that it would also consider factors such as whether:

- (i) the hedge clause is written in plain English;
- (ii) the hedge clause is individually highlighted and explained during an in-person meeting with the client;
- (iii) enhanced disclosure is provided to explain the instances in which the client may still have a right of action; and
- (iv) any assistance provided by an intermediary to the client in negotiating the contract, the extent of that assistance and the intermediary's degree of sophistication in legal matters.

### ➤ NASD Issues Notice to Members Regarding Oversight of Recommendations Made by Registered Representatives That Have Just Changed Firms

The NASD issued a Notice to Members (the "NTM") regarding special considerations in the supervision of a registered representative with an established customer base that moves to a new firm. The NTM focuses on situations where the newly associated registered representative's customer base holds assets that cannot be transferred to the successor firm and the registered representative recommends that those assets be liquidated and replaced with others that can be maintained at the successor firm. The NTM notes that these situations may arise with respect to (a) mutual funds or variable products (i) that a customer holds directly with the product issuer or (ii) that are proprietary to the predecessor firm and not transferable and (b) nonproprietary products that are not freely transferable because their sponsor does not have a dealer or servicing agreement with the successor firm. The NTM discusses the special duties of a registered representative in recommending that a customer sell any such product and replace it with a new one, as well as those of the successor firm in overseeing the registered representative's activities with respect to the transferring customer base. The NTM lists oversight measures that a successor firm should have in place, including (i) due diligence procedures that examine the nature of the registered representative's business in order to identify situations where the registered representative's existing customer base holds products for which the successor firm does not have the necessary dealer or servicing agreements in place and (b) procedures for the review of recommendations to liquidate or surrender existing mutual fund and variable product holdings made by a newly associated registered representative to the registered representative's existing customer base.