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Developments of Note

➤ **FRB and SEC Finalize Regulation R**

The FRB and the SEC approved Regulation R ("Final Regulation R") implementing the bank broker push out provisions under Title II of the Gramm-Leach-Bliley Act of 1999 ("GLBA"). A bank or thrift (collectively, a "bank") must start complying with Regulation R on the first day of the bank's fiscal year starting after September 30, 2008, which for many banks will be January 1, 2009.

Regulation R was proposed by the FRB and the SEC jointly in an effort to resolve a years-long impasse between the SEC and banks regarding the appropriate interpretation of 11 statutory exceptions in the GLBA. The exceptions were intended to preserve bank activity after Congress repealed the blanket bank exception from broker regulation. The repeal was long-sought by the SEC in order to provide for functional SEC regulation of bank broker activities in response to banks' entry into broader financial services securities activities, including the retail sale of mutual funds, in the 1980s.

To provide greater certainty to banks, the SEC made several attempts to issue regulations (proposed Regulation B in 2004 and the Bank Broker-Dealer Interim Final Rules in 2001) – these attempts were criticized by banks, banking agencies, and some members of Congress. Last fall, in adopting the Financial Services Regulatory Relief Act of 2006, Congress required the SEC to withdraw its rules and issue new rules jointly with the FRB in consultation with the other federal banking agencies.

Final Regulation R generally reflects proposed Regulation R, but also addresses banks' concerns regarding legal and enforcement risk and contains further easing of bank regulatory burden in discrete areas, notably the "chiefly compensated" income test for exempted trust/fiduciary activity, the types of referral compensation permitted under the networking exemption, the scope of exempted custody activity, sweeps of deposit funds collected by another bank, and exempted transactions in variable insurance products effected with an insurance company.

Significant changes made by Regulation R, in comparison with previous proposals, are summarized below.

Interpretation and Enforcement. The FRB and SEC have stated in the draft Federal Register notice announcing the adoption of Final Regulation R that they will jointly issue any interpretations or no-action letters/guidance. Significantly, regarding formal enforcement actions, the two agencies have stated that they will consult with each other and the appropriate federal banking agency and coordinate when appropriate.

Exchange Act Section 29(b) Rescission Risk. Banks will be provided a transitional 18-month exemption to prevent contracts with customers involving securities processing from being void or voidable under Section 29(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as a result of violation of the conditions on the 11 bank exceptions in the GLBA. Banks will further be provided a permanent exemption from Section 29(b) where a bank has acted in good faith and had reasonable policies and procedures in place to comply with the bank broker rules and regulations, and any violation of the registration requirements did not result in any significant harm, financial loss, or cost to the person seeking to void the contract. Accordingly, banks’ policies and procedures for compliance with Final Regulation R will be important to reducing legal risk.

Trust and Fiduciary Exception “Chiefly Compensated” Test. The GLBA created an exception from broker regulation for a bank’s trust and fiduciary activities involving securities processing on the condition the bank is “chiefly compensated” for its trust/fiduciary activities by administration fees, annual fees, fees based on assets under management, flat or capped per order processing fees not exceeding execution cost, or a combination, called “relationship compensation,” rather than by securities sales compensation. The attempt to address this exception in the SEC’s Regulation B proposal was criticized on the bases that the chiefly compensated test would be difficult to calculate and that traditional bank fiduciary compensation, such as 12b-1 fees paid by mutual funds, was not considered relationship compensation. To address these concerns, proposed Regulation R opted for easier tests to allow a bank to meet the chiefly compensated test under either (1) an account-by-account calculation that the bank received greater than 50% of its compensation from relationship compensation or (2) a bank-wide calculation that the bank’s aggregate relationship compensation from trust and fiduciary accounts is at least 70% of total compensation. Proposed Regulation R also clarified that relationship compensation includes 12b-1 fees, shareholder servicing and sub-accounting fees traditionally paid by mutual funds to banks.

Final Regulation R:

- adopts the proposed the 50% account-by-account and 70% bank-wide compensation tests (measured as a two-year rolling average) and treats 12b-1, shareholder servicing and sub-accounting fees as relationship compensation,
- provides new examples of trust/fiduciary account fees that qualify as relationship compensation (including administration fees charged in connection with securities borrowing or lending transactions, and fees for providing custody services), and
- contains a new exemption for trust and fiduciary accounts held at a foreign branch, permitting a bank to exclude such accounts at a “non-shell” branch from its bank-wide chiefly compensated calculation if the bank has reasonable cause to believe that less than 10 percent of the accounts are held by/for a U.S. person.

Custody Exception. While the GLBA contains a statutory exception for custody activities, the SEC has not viewed the statutory exception as generally permitting banks to handle securities transactions. Proposed Regulation B exempted “qualified investor” (\$25 million invested) custody accounts and conditionally grandfathered existing non-qualified accounts. Regulation R as proposed would have expanded the custody exemption to permit banks to conduct “accommodation” transactions for custody accounts and provide custody services to employee benefit plan accounts and IRAs, both subject to restrictions on bank employee incentive compensation and advertising. Accommodation trades were to be subject to additional restrictions on investment advice and fees dependent on an order or its size.

Final Regulation R:

- adopts proposed Regulation R’s broadening of the custody exemption,

- permits a bank acting as a directed trustee without investment discretion to rely on either the trust/fiduciary or custody exemption, allowing the bank to choose the exemption with requirements best matching the bank's activity,
- will not be construed to prevent a bank from cross-marketing its trust/fiduciary or other services to custody customers or providing samples of research,
- clarifies the "carrying broker" restriction on the custody exemption - a bank may not enter into arrangements or act with a broker-dealer to cause the broker-dealer's customers to use the bank's custody accounts, rather than maintaining funds/securities in broker-dealer accounts, in avoidance of SEC financial and other responsibility rules,
- extends the custody exemption to a bank acting as sub-custodian for another custodial bank, and
- expands the circumstances in which a bank administrator or recordkeeper for an employee benefit plan may net orders or engage in cross-trades.

Networking Referral Fees. The GLBA exception for networking arrangements between banks and brokers, permitting retail brokerage services on bank premises, limits bank employee referral fees to a "nominal" one-time cash fee that is not contingent on whether the referral results in a transaction. Regulation B's proposed interpretation of "nominal" and other statutory conditions on networking was criticized as interfering with networking arrangements or existing bank bonus plans.

Regulation R as proposed would have eased referral fee restrictions as compared to Regulation B, so that an employee referral fee would be "nominal" if it did not exceed the greater of (1) twice the average minimum and maximum hourly wage for the employee's job category (e.g., teller), (2) twice the employee's actual base hourly pay, or (3) \$25 adjusted in the future for inflation. Regulation R as proposed would have permitted bonus plan compensation based on multiple factors including securities transactions and clarified that bonuses can be paid based on overall bank or bank unit profitability.

In addition, proposed Regulation R included an exemption from the "nominal" referral fee requirement for referrals of institutional and high net worth customers (with "institutional customer" meaning a non-natural person with \$10 million in investments or \$40 million in assets, and "high net worth customer" meaning a natural person with \$5 million in net worth not counting the primary residence).

Proposed Regulation R also required bank employee disclosure of financial interest in a referral and a suitability or sophistication analysis of a customer by the broker-dealer partner.

Final Regulation R:

- generally adopts proposed Regulation R,
- adds to proposed Regulation R's three methods of meeting the "nominal" referral fee a fourth method under which a referral fee qualifies if it does not exceed 1/1000th of the employee's actual annual base salary,
- modifies the definition of "institutional customer" to include a \$20 million in revenues test, in lieu of a proposed \$40 million in assets test,
- clarifies that a "high net worth customer" also includes a revocable, inter vivos or living trust the settlor of which is an individual,
- eases the disclosure requirement by permitting oral disclosures if written disclosures are provided within certain time periods, and
- eliminates a condition in proposed Regulation R requiring both the bank and the broker-dealer to determine whether the referring employee is subject to statutory disqualification (only the broker-dealer will be required to make the determination).

Bank Use of Money Market Fund Exemptions for Deposits Held or Collected by Another Bank. Final Regulation R clarifies that a bank may use either the GLBA exception for sweeps or the Regulation R exemption for money market fund transactions on behalf of another bank as part of a program for the investment or reinvestment of deposit funds held or collected by the other bank. The change clarifies that banks can provide sweep services to *other banks* under the money market fund exemption, as they can under the GLBA sweep exception itself.

Bank Effecting Variable Annuities and Variable Life Insurance Contracts. Final Regulation R clarifies that a bank, relying on the trust/fiduciary or another exemption to effect transactions in variable annuities or variable life insurance contract, may effect trades in these instruments directly with the relevant insurance company subject to conditions similar to those under which Final Regulation R permits mutual fund trades to be effected directly with the fund's transfer agent or the National Securities Clearing Corporation.

Bottom Line – Bank Activities Not Subject to Broker Regulation. Combining the GLBA statutory exceptions and those in Final Regulation R, bank activity of the following types generally will not be considered “broker” activity under the Exchange Act and may be conducted by banks subject to explicit conditions and limitations:

- Networking arrangements
- Trust and fiduciary activities
- Safekeeping and custody
- Sweeps and other transactions in money market mutual funds
- Permissible securities (U.S. government securities, commercial paper, bankers acceptances)
- Stock purchase plan transactions as transfer agent (pension, profit-sharing, bonus, dividend reinvestment or issuer purchase)
- Affiliate transactions
- Private placements
- Identified banking products (including loan participations, equity swaps and derivatives)
- Municipal securities
- *De minimis* transactions (up to 500 transactions per year)
- Transactions for employee benefit plans
- Transactions in SEC Regulation S securities

Next Steps for Banks. Banks will need to assess their activities that involve “effecting” securities transactions (including escrow, trust, fiduciary, custody, conservator/guardian and networking) and take steps to comply with Final Regulation R's exemptions and their specific conditions (including marketing, compensation and disclosure requirements) by banks' respective compliance dates in 2008 or 2009. As a practical matter, banks will need to adopt internal policies and procedures for ensuring compliance with Final Regulation R, in order to be eligible for the permanent exemption from Exchange Act Section 29(b) rescission. In conjunction with adopting Final Regulation R, the SEC modified its bank dealer rules to make them consistent with Final Regulation R. Banks should consider these modifications in assessing their dealer activities.

Next Steps for Regulators. Section 204 of the GLBA required the federal banking agencies, in consultation with the SEC, to adopt recordkeeping requirements for banks to demonstrate compliance with the bank activity exceptions in the GLBA. The recordkeeping rules, delayed by the impasse over bank broker rules, will now be considered. The federal banking agencies also intend to issue

supervisory guidance to ensure banks have adequate policies, procedures and systems to comply with Final Regulation R. The SEC and banking agencies will continue a dialogue with the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization for U.S. brokers-dealers formed by the merger of NASD and NYSE regulation, regarding NASD Rule 3040 governing dual bank/broker employees.

➤ SEC Staff Grants No-Action Relief from Advisers Act Custody Requirements for Inadvertent Receipt of Client Assets from Third Party

The staff of the SEC's Division of Investment Management granted no-action relief from the requirements of Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), to permit a registered adviser to forward client assets it inadvertently receives to the client (or former client) or to a qualified custodian (as defined under the Rule) in limited circumstances. The Custody Rule provides that an adviser may not "[hold], directly or indirectly, client funds or securities, or [have] any authority to obtain possession of them," unless, among other things: (1) a qualified custodian, as defined under the Custody Rule, maintains those assets in the manner required by the Rule; and (2) the adviser (i) has a reasonable belief that the qualified custodian sends quarterly account statements to the clients or (ii) sends quarterly account statements to the clients. The Custody Rule defines "custody," in pertinent part, to include "possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless [the adviser receives] them inadvertently and [returns] them to the sender promptly but in any case within three business days of receiving them." The request for relief was prompted by concern that under certain circumstances returning client assets to third parties that had sent those assets to an adviser delayed client access to the assets and increased the risk that the assets would be lost since the third parties were unlikely to be fiduciaries for the clients.

The no-action relief allows an adviser to forward client assets it inadvertently receives to the client or a qualified custodian under the following circumstances:

Tax refunds. An adviser that provides administrative services to its clients in connection with tax filings made with the Internal Revenue Service, state and other governmental taxing authorities (that include completing and filing tax forms) receives a client's tax refund;

Settlement distributions. An adviser that files proofs of claim for its clients and completes other documentation related to class action lawsuits and other legal actions receives settlement proceeds for a client directly from the administrators of funds (including Sarbanes-Oxley Fair Funds) established to distribute those proceeds; and

Securities and dividend checks. An adviser receives stock certificates or dividend checks in the name of its clients, *e.g.*, stock certificates (or evidence of new debt) distributed in a class action lawsuit involving bankruptcy where shares are issued in a newly organized entity, or as a result of a business reorganization.

In order to rely on the relief, an adviser must have no control over the third party that sent the client assets and must not have directly or indirectly caused the third party to deliver the client assets. In addition, the adviser must have, in good faith, used its reasonable best efforts to cause the third party to deliver client assets to the client or a qualified custodian at which the adviser maintains its client assets. The adviser must promptly forward client assets that it inadvertently receives from third parties within five business days of receiving the assets, to its client (or former client) or a qualified custodian. An adviser that inadvertently receives client assets from third parties in more than rare or isolated instances must adopt and implement written policies and procedures reasonably designed to ensure that the adviser does the following:

1. promptly identifies client assets that it inadvertently receives;

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2. promptly identifies the client (or former client) to whom the assets are attributable;
3. promptly forwards client assets to its client (or former client) or a qualified custodian, but in no event later than five business days following the adviser's receipt of such assets;
4. promptly returns to the appropriate third party any inadvertently received client assets that the adviser does not forward to its client (or former client) or a qualified custodian, but in no event later than five business days following the adviser's receipt of the assets; and
5. maintains and preserves appropriate records of all client assets inadvertently received by it, including a written explanation of whether (and, if so, when) the client assets were forwarded to its client (or former client) or a qualified custodian, or returned to the third party.

The SEC staff expects that an adviser that inadvertently receives client assets from third parties in only rare and isolated instances would act in a manner that is consistent with (1) – (5) above. In granting the relief, the SEC staff noted that additional situations may arise in the future in which it would consider further relief in this area.

Other Item of Note

➤ CFTC Provides No-Action Relief Allowing Commodity Pool's Investment Manager to Register as CPO In Lieu of Pool's General Partner

The CFTC's Division of Clearing and Intermediary Oversight took a no-action position allowing the investment manager of a commodity pool to serve as the pool's registered Commodity Pool Operator ("CPO") instead of the pool's general partner. The Division's position was based upon representations that: (1) the investment manager was registered as a CPO; (2) the general partner and the investment manager were under common ownership and control; (3) the general partner did not engage in solicitation of pool participants or any other pool operator functions; and (4) the general partner and the investment manager executed cross acknowledgments of joint and several liability for any violations by the other of the Commodity Exchange Act and the CFTC's rules. The no-action position was expressly conditioned upon continued registration as a CPO of the investment manager.