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Developments of Note

➤ **FRB Approves Indian Bank's Establishment of U.S. Branch Without a Comprehensive and Consolidated Supervision Finding**

The FRB approved the application of India's second largest bank, ICICI Bank Limited ("ICICI"), to establish a branch office in New York. According to the FRB, the office will provide wholesale banking services to U.S. subsidiaries of Indian firms. The FRB's approval is noteworthy because it was granted to ICICI without a finding that the bank is subject to comprehensive and consolidated supervision.

Under the International Bank Act ("IBA"), the FRB must consider various factors in approving an application by a non-U.S. bank to establish a branch in the United States. The FRB must consider, for example, whether the non-U.S. bank has furnished the agency with sufficient information to assess the bank's application and whether the non-U.S. bank is subject to "comprehensive supervision on a consolidated basis by its home country supervisors." In making the latter determination, the FRB considers, among other factors, the extent to which a bank's home country supervisors have adequate procedures for monitoring and controlling the bank's worldwide activities, and are able to obtain information on the condition of the bank and its affiliates worldwide and evaluate prudential standards, such as capital adequacy, on a worldwide basis.

In this case, the FRB approved ICICI's application using a limited exception to the IBA's comprehensive and consolidated supervision standard. The exception grants the FRB discretion to approve an application if the agency finds that the bank's home country authorities are "actively working" to establish consolidated supervision of the bank and all other factors are consistent with approval. In determining whether to exercise such discretion, the FRB considers whether the non-U.S. bank has implemented adequate anti-money laundering ("AML") controls and may take into account whether the home country is developing an adequate AML legal regime.

The FRB concluded that the Reserve Bank of India ("RBI"), ICICI's principal banking regulator, is actively working to establish arrangements for the consolidated supervision of the bank. The FRB also

noted that the Indian government has in recent years enhanced its AML regime, including through the creation of new government agencies responsible for investigating and prosecuting money laundering. In addition, ICICI was cited by the FRB as having put in place an enterprise-wide, risk-based set of AML policies and procedures.

The FRB's approach may provide useful precedent for other non-U.S. banks, including banks from China, which are seeking entry into the United States. Several Chinese banks have sought to establish branches in the United States but, the FRB has not heretofore found Chinese banks to be subject to consolidated and comprehensive supervision.

There also has been speculation that the FRB's decision was intended to influence the Indian government's posture with respect to entry by U.S. banks into the Indian banking market. Currently, U.S. banks face significant difficulty in obtaining RBI approval to establish branches in India.

➤ **DOL Finalizes Regulation Relating to Default Investment Alternatives**

The Department of Labor (the "DOL") finalized a regulation (the "Final Regulation") concerning a safe harbor for ERISA plan fiduciaries who invest the assets of participants in a participant-directed defined contribution plan (a "Plan") subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Final Regulation is effective December 24, 2007.

Because many employees do not elect to participate in their employer's defined contribution plans (such as 401(k) plans), some employers have adopted automatic enrollment provisions under which employees are automatically enrolled in a Plan unless they affirmatively opt-out of plan participation. However, a large percentage of employees who are enrolled in such plans in this manner fail to provide investment directions, which in the past has often resulted in their accounts being invested in a conservative investment option selected by plan fiduciaries who wish to avoid liability for a decline in the value of the participant's account. The safe harbor provides protection designed to enable plan fiduciaries to utilize less conservative default options. In addition, as long as the conditions are satisfied, the safe harbor can apply outside the automatic enrollment context.

The Pension Protection Act of 2006 (the "PPA"), added Section 404(c)(5)(A) to ERISA. This section provides that, under Section 404(c)(1) of ERISA (which generally relieves plan fiduciaries of responsibility for investment decisions made by the plan participants when certain conditions are satisfied), a fiduciary will not be treated as exercising control over assets that are invested in accordance with regulations prescribed by the DOL. The Final Regulation allows plan fiduciaries to avail themselves of relief similar to that offered by Section 404(c)(1) of ERISA when they invest participant assets in a qualified default investment alternative (a "QDIA") and certain conditions are satisfied.

Under the Final Regulation, an investment alternative generally will qualify as a QDIA only if (1) it does not impose financial penalties or otherwise restrict the ability of a participant or beneficiary to opt out of the Plan or to direct their own investments; (2) it either (i) is managed by an investment manager (as defined in ERISA), a Plan trustee that could qualify as an investment manager under ERISA or a Plan sponsor who is a named fiduciary, or (ii) is an investment company registered under the Investment Company Act of 1940 (*i.e.*, a mutual fund); (3) it does not generally invest participant contributions directly in employer securities; and (4) it is a life cycle or targeted-retirement-date fund, a balanced fund or a professionally managed account, all of which are required to meet certain requirements, including that they be diversified so as to minimize the risk of large losses. The Final Regulation adds short-term investment, capital preservation products to the list of investment alternatives which can qualify as a QDIA, but only for the first 120 days of Plan participation.

In addition, in order for the relief under the Final Regulation to be available, participants and beneficiaries must have been (1) given opportunity to provide investment direction (but failed to have done so); (2) furnished with notice as provided in the Final Regulation; (3) provided with materials, such as investment prospectuses and other notices relating to the QDIA, generally provided under the

Plan; and (4) given the opportunity to direct investments out of a QDIA with the same frequency as is available for other plan investments (but no less frequently than quarterly). A Plan must also offer a “broad range of investment alternatives” as defined in the DOL’s regulation under Section 404(c) of ERISA. It is important to note that the Final Regulations do not relieve Plan fiduciaries of liability for the prudent selection and monitoring of the particular QDIA for the Plan.

Another important aspect of the Final Regulation is that stable value products will not qualify as QDIAs for contributions invested after December 24, 2007 (except under the limited 120-day rule described above). However, since many plan sponsors utilized stable value products as their default investment prior to the PPA and the Final Regulation, the Final Regulation “grandfathers” such arrangements by providing the QDIA safe harbor to contributions invested in stable value products prior to the effective date of the Final Regulation.

➤ **Federal Appeals Court Holds That Connecticut Gift Card Expiration Prohibition Preempted, but Restrictions on Fees Are Not Preempted**

The United States Court of Appeals for the Second Circuit (the “Appellate Court”) decided that the Connecticut Gift Card Law’s prohibition on gift card expiration dates was preempted by the National Bank Act, but the Gift Card Law’s fee restrictions were not. SPGGC, a nonbank, sold gift cards with expiration dates and collected gift card-related fees. The gift cards were issued by Bank of America, a national bank and Visa member-bank. The Connecticut Attorney General informed SPGGC that it intended to bring an enforcement action against SPGGC for violating the Gift Card Law’s prohibition of expiration dates and certain fees. SPGGC filed suit in federal district court seeking a declaratory judgment that the Attorney General’s proposed enforcement action was preempted by the National Bank Act.

The district court dismissed SPGGC’s complaint, ruling the provisions of the Gift Card Law in question were not preempted. The Appellate Court affirmed the trial court’s ruling regarding the Gift Card Law’s restrictions on fees collected by SPGGC, reasoning that the fee restrictions only impacted SPGGC, and did not interfere with Bank of America’s ability to exercise its powers under the National Bank Act. The Appellate Court, however, disagreed with the district court’s ruling with respect to the Gift Card Law’s prohibition on gift card expiration dates. In vacating and remanding this part of the ruling, the Appellate Court concluded that, because Visa required its member banks to include expiration dates on gift cards, prohibiting them would prevent Bank of America from exercising its power under the National Bank to issue gift cards. *SPGGC, LLC v. Blumenthal*, No. 05-4711 (2d Cir. Oct. 19, 2007).

➤ **Amendment to New York State Banking Law Provides for New Wild Card Authority**

The New York State legislature amended New York’s Banking Law to provide for a new “wild card” authority under Section 12-a of the Banking Law. Effective September 1, 2007, the New York Banking Board now has the power to grant applications by New York State-chartered banking institutions, as well as licensed foreign bank branches and agencies, to exercise powers possessed by a similar federally-chartered banking institution. Before this amendment’s enactment, wild card powers could only be adopted by regulation, which involved a much longer process.

Under the new law, the Banking Board may approve applications by New York chartered banks and New York licensed branches and agencies of foreign banks to exercise a “federally permitted power,” defined as “any right, power, privilege or benefit, any activity, or any loan, investment or transaction which a federally chartered banking institution directly or through a subsidiary or subsidiaries, may lawfully exercise or into which it may lawfully engage or enter.” However, the statute only permits state chartered or licensed institutions to exercise federally permitted powers of its “counterpart” federally chartered banking institution. Thus, for example, a New York bank or trust company could obtain authority to exercise a federally permitted power of a national bank, and a New York savings bank could seek authority to exercise a federally permitted power of a federal savings association.

A state-chartered institution may receive wild card powers either (i) by applying, alone or in concert with other state-chartered banking institutions, to the Superintendent of Banks, specifying the federal power it wishes to exercise and the basis upon which it believes that power is permitted, or (ii) through a recommendation by the Superintendent in his or her sole discretion. In each case, the wild card power must be subject to the same terms and conditions as applicable to a federally-chartered banking institution, and also may be subject to such terms and conditions as the Superintendent finds necessary and appropriate, as approved by the Banking Board. In reviewing any recommendation by the Superintendent to grant a wild card power (whether by application by the financial institution or by the Superintendent's sole discretion), the Banking Board must determine whether the recommendation is, first, consistent with the policy of the New York Banking Law and, second, necessary to achieve or maintain parity between state-chartered institutions and their federal counterparts.

Under the amended statute, the Banking Board cannot approve an application until at least 30 days after notice of the application is posted. The Superintendent's determination whether to recommend approval of the application and any recommendation to the Banking Board is to be made within 45 days after the posting of the application; however, the statute provides for an extended period of review at the Superintendent's discretion. The Banking Board, upon the recommendation of the Superintendent, may by resolution make approval of an application under the wild card authority applicable to one or more additional state chartered banks that are qualified to exercise the same powers as the applicant bank or banks.

The new law contains a savings provision that preserves limitations previously imposed by the Banking Board by regulation on the ability of state chartered institutions to exercise federally permitted powers unless such regulations are superseded, modified or revoked by the Banking Board pursuant to the new wild card law, and it contains a sunset provision under which the Banking Board's authority to authorize federally permitted powers will expire on September 10, 2009. Furthermore, the new law provides that the wildcard powers do not supersede certain specified provisions of the Banking Law.

The Superintendent has stated that he is already reviewing a number of wild card proposals that he will potentially bring to the Banking Board for resolution. The Superintendent further stated that he encourages institutions to review their options under this law and submit applications for consideration.

➤ **Director of SEC's Division of Investment Management Discusses Regulatory Issues for Separately Managed Accounts**

At the 2007 Managed Account Solutions Conference, Andrew J. Donohue, Director of the SEC's Division of Investment Management (the "Division"), discussed regulatory issues the SEC and the Division are addressing in the area of separately managed accounts ("SMAs"). The topics addressed in Mr. Donahue's speech were (a) Temporary Rule 206(3)-3T (the "Temporary Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), (b) the SEC's Investment Adviser/Broker-Dealer Study, (c) Form ADV Part 2, (d) best execution and (e) Rule 3a-4 under the Investment Company Act of 1940, as amended (the "1940 Act").

Temporary Rule 206(3)-3T. Mr. Donohue discussed the background of the Temporary Rule and the prospects for further action by the SEC in dealing with the issue of fee-based brokerage accounts. Mr. Donohue reviewed the decision by the Federal Court of Appeals for the D.C. Circuit in *Financial Planning Association v. SEC* (the "FPA Decision"), which vacated a SEC rule that, in general terms, provided that fee-based brokerage accounts were not advisory accounts subject to the Advisers Act (see the April 10, 2007 *Alert* for a discussion of the FPA Decision and the May 22, 2007 *Alert* for a discussion of the SEC's decision not to challenge the FPA Decision). He noted that the Division's staff, in discussing the effect of the decision with affected firms, was told that for practical reasons many broker-dealers had structured their fee-based brokerage accounts in a manner that prevented their responding to the FPA Decision by simply applying the Advisers Act to those accounts; as a consequence, those firms were asking their fee-based brokerage account customers to convert their accounts either to advisory accounts or to traditional commission-based brokerage accounts.

Broker-dealers also told the Division that the requirements of Section 206(3) of the Advisers Act, which imposes restrictions on principal trading with clients, including the requirement of prior consent to each principal transaction, would make it impractical for the firms to offer their fee-based brokerage customers who convert to advisory accounts transactions in certain securities that they offer on a principal basis, *e.g.*, debt obligations such as municipal bonds. These broker-dealers represented to the Division that many of their fee-based brokerage customers, as a practical matter, would be unable or unwilling to transition to an advisory account. In order to allow fee-based brokerage customers who convert to advisory accounts to continue to have access to a firm's inventory of securities, the SEC adopted the Temporary Rule, which permits an adviser that is also a registered broker-dealer to engage in principal transactions with a non-discretionary client account subject to less restrictive conditions than those applicable under Section 206(3). The Temporary Rule contains a sunset provision that will cause it to expire on December 31, 2009, absent further action by the SEC. The SEC requested comment on all aspects of the Temporary Rule, with the comment period closing on November 30, 2007. Mr. Donohue noted that when he last checked, the SEC had not yet received any comments on the Temporary Rule. He did, however, indicate that he had seen a press report indicating that some investment advisers may have an interest in recommending that the relief afforded by the Temporary Rule be expanded to apply to advisers with affiliated broker-dealers. The same press report also indicated that some advisers may have an interest in recommending that the relief be expanded to include discretionary advisory accounts, such as SMAs.

Investment Adviser/Broker-Dealer Study. Mr. Donohue noted that following the FPA Decision, SEC Chairman Cox approved additional emergency funding to accelerate a study of the broker-dealer and investment adviser industries commissioned in connection with the SEC rulemaking vacated by the FPA Decision (see the March 7, 2006, July 11, 2006 and August 8, 2006 *Alerts* for more on the study). As a result, the study will be delivered to the SEC no later than December of this year, several months ahead of schedule. He observed that the study should help the SEC more fully evaluate how it can improve investor protection by updating its regulations to deal with the realities of today's marketplace.

Form ADV Part 2. The Division is currently working on a recommendation to the Commission to re-propose amendments to Part 2 of Form ADV. Form ADV Part 2, which provides information about the adviser's business, the background of its advisory personnel, disciplinary information and conflicts of interest, is the principal disclosure document investment advisers provide to clients and prospective clients. In 2000, the SEC implemented substantial amendments to Part 1 of Form ADV, which included implementing electronic filing of Part 1 via the IARD electronic registration system and establishing the Investment Adviser Public Disclosure (IAPD) website, which makes Part 1 information publicly available. The SEC delayed adopting proposed amendments to Part 2 in 2000 in part to allow it time to more fully consider the many comments it received on proposed Part 1 revisions. Mr. Donohue observed that since 2000 there have been significant changes in the investment advisory industry, including the introduction of new types of managed accounts as well as significant regulatory changes in the form of new requirements for chief compliance officers, written compliance policies and procedures and codes of ethics. He stated that in light of the changed business and regulatory landscape, the Division was going to recommend that the Commission re-propose amendments to Part 2 in order to allow for fresh comment on the initiative before any final action. He noted that the original Part 2 proposal issued in 2000 involved changing Part 2 from its current check-the-box format with continuation sheets for additional explanatory material to a free-form text, plain English, narrative document. The proposed changes were based on the SEC's positive experience with Schedule H to Form ADV, a narrative disclosure document advisers must provide to wrap program clients. He indicated that he was hopeful that the Division could incorporate the positive experience with Schedule H into revised Form ADV Part 2.

Best Execution. Mr. Donohue reminded his audience that the goal of seeking best execution should not be limited to equity trades, and that best execution inquiries should be made across all accounts and products, each of which, including SMAs, may have its own best execution issues and challenges. He observed that if asset management clients are in arrangements, such as SMAs, in which the placement of trades may be based on or influenced by factors other than an attempt to achieve best execution, the

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client should be fully informed of, and consent to, the arrangement. For example, clients being asked to consent to an arrangement where trades will be placed with an SMA's sponsor should be told why the trades are placed with the SMA's sponsor and the impact that placement may have on execution of trades. He observed that there can be legitimate reasons for an asset manager to place an SMA client's trades with the SMA's sponsor, *e.g.*, when the client is paying a single fee for both asset management and trade execution services. Thus, if the asset manager places a trade with a broker-dealer other than the SMA sponsor, the SMA client incurs a separate charge, possibly one the client was not expecting. At the same time he added there is the possibility that a non-SMA sponsor broker-dealer may be in a position to provide better execution in a particular circumstance. He urged SMA market participants to consider the extent to which this situation exists and the extent to which clients are informed of the way the trade placement decisions are made in the SMA context.

Rule 3a-4. In conclusion, Mr. Donohue reiterated his belief expressed in prior speeches that a critical regulatory function is the review of relevant rules to ensure that they continue to be effective and workable. In this context, he specifically mentioned Rule 3a-4 under the 1940 Act, which provides a safe harbor from the definition of investment company for certain programs that provide discretionary investment advisory services to clients. He solicited comment on whether Rule 3a-4 as written, as interpreted or as implemented should be modified.

Other Item of Note

➤ FRB To Discuss Basel II at November 2 Board Meeting

The agenda for the FRB's November 2, 2007 Board meeting states that the FRB will discuss and consider the final Basel II risk-based capital rules, which are applicable to the largest US banking institutions. The FRB staff memorandum will be made available to the public at the time of the meeting.