

Financial Services Alert

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Developments of Note

➤ **FRB Authorizes BHC Ownership of SHLC Preferred Stock Convertible into Greater than 5% Voting Stock**

The FRB issued a letter authorizing a bank holding company (“BHC”) to acquire nonvoting convertible preferred stock (the “Preferred Stock”) of a savings and loan holding company (“SLHC”) representing approximately 15% of the SHLC’s total equity and convertible by its terms at the option of the BHC into approximately 15.7% of the voting common stock of the SLHC without requiring the BHC to apply for such ownership under Section 4 of the Bank Holding Company Act (the “BHCA”). The letter provides that the preferred stock itself would meet the Regulation Y standard for nonvoting stock. Moreover, the BHC made several commitments designed to limit its control over the SLHC, including that it will not exercise a controlling influence over the SLHC’s management, that it will not have any representation on the SHLC’s board of directors (except in the event of nonpayment of dividends for six quarters), that it will not convert the Preferred Stock to more than 4.9% of a class of voting securities without FRB approval, and that it generally will not transfer to an unaffiliated party stock convertible into 5% or more of the voting stock of the SLHC. Based on these commitments, the FRB determined that notwithstanding the general presumption in Regulation Y that stock convertible into voting stock at the option of a banking institution is deemed to be voting stock for purposes of the Regulation Y limitations, the investment in the Preferred Stock by the BHC would be permissible without prior FRB approval under Section 4(c)(6) of the BHC Act (which generally applies to investments representing less than 5% of the voting securities and less than 25% of the total equity of a nonbanking enterprise).

➤ **SEC Settles with Hedge Fund Adviser over Failure to Make Form 13F Filings Regarding Client Securities Holdings**

The SEC settled administrative proceedings that it proposed to bring against a registered adviser to a group of hedge funds regarding the adviser’s repeated failure to file Forms 13F with the SEC between 2002 and mid 2005. Section 13(f) of the Securities Exchange Act of 1934, as amended (the “1934 Act”), and Rule 13f-1 under the 1934 Act require institutional investment managers that exercise investment discretion over \$100 million or more of Section 13(f) securities as of the last trading day of any month to file Forms 13F with the SEC. Section 13(f) securities, which consist of certain exchange-

traded equities (including certain convertible debt securities) described in Rule 13f-1, appear on the SEC Official List of Section 13(f) Securities. An institutional investment manager must make Form-13F filings that disclose specific Section 13(f) securities holdings under the manager's discretion as of the end of the December quarter of any calendar year during which the \$100 million threshold is reached and as of the end of the March, June and September quarters of the following year.

In its order of settlement, the SEC found that since 2001 the adviser's assets under management exceeded the \$100 million threshold in Section 13(f) securities, with the result that the adviser should have filed a Form 13F each quarter beginning in 2002. The SEC further found that the adviser failed to file Forms 13F until July 2005 when the SEC's inspection staff questioned the adviser about the lack of such filings. According to the SEC's findings, the adviser had notice of the Form 13F filing requirement prior to July 2005 in, for example, (i) various drafts of the adviser's compliance manual and the final manual itself, which was implemented at the end of January 2005, (ii) a January 2005 memorandum sent by the adviser's outside counsel to all its hedge fund clients describing Form 13F requirements and filing deadlines and (iii) a January 2005 e-mail reminder from the adviser's outside auditor regarding Form 13F requirements. In response to the SEC staff's inquiries, the adviser began filing Form 13F and filed retrospective Forms 13F covering the period from 2002 to mid-2005. Among other things, the settlement requires the adviser to pay a civil money penalty of \$100,000. In discussing the importance of information provided pursuant to Section 13(f) of the Exchange Act to the SEC in its oversight of market practices, the settlement order notes the current need for that information, "when institutional investment managers oversee in excess of \$1 trillion of hedge fund investments."

➤ **FRB Relaxes Risk Capital Requirements for Securities Collateralized Loans**

The FRB published an interpretive letter relaxing the standard risk-based capital guidelines for securities borrowing transactions. Under the standard guidelines, a bank that has adopted the market risk capital rule can exclude loans from risk weighted assets to the extent of the market value of the borrowed securities if the loan: (1) is based on securities includable in the trading book that are liquid and readily marketable; (2) is marked to market daily; (3) is subject to daily margin maintenance; and (4) is done on an overnight basis, is unconditionally cancellable by the bank, or is effectively exempt from automatic stay in bankruptcy.

The securities loans at issue would satisfy (2)-(4) of the above conditions. The collateral for the loans also would have a value that the banking organization believes would be in excess of the amount loaned, "with the amount of the excess depending on the creditworthiness of the obligor and other relevant credit considerations." In the letter, the FRB states that these transactions would qualify for the standard securities borrowers rule risk capital exemption if the securities collateral involved securities includable in the trading book and liquid and readily marketable. The FRB then determined banking institutions could treat these transactions as if they met all 4 requirements of the securities borrowing rule, with the FRB stating that it "would expect the banking organization to have a reasonable and appropriate basis for valuing the collateral." Moreover, to highlight the possible uses of this relief, the letter expressly provides that the relief would be available whether it was moderated by the banking organization's desire to borrow securities or lend cash, so long as the conditions are satisfied.

➤ **FINRA Clarifies Privacy Issues with Respect to its Guidance Regarding Supervision of Newly Associated Registered Representatives**

FINRA (then known as the NASD) issued a Notice to Members (the "NTM") in February 2007 discussing special considerations for member firms in supervising recommendations made by newly hired registered representatives (in connection with their transition to successor firms) that their clients replace existing mutual fund or variable product investments (as discussed in the February 20, 2007 *Alert*). The NTM recommended that a successor firm conduct due diligence concerning a registered representative proposed to be hired from another firm in order to learn the extent to which the representative offers investment products for which the successor firm would need a dealer or servicing agreement in order for the representative to be able to continue to sell, and provide service with respect

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to, those products. In response to questions from members regarding the scope of due diligence described in the NTM and whether that due diligence may conflict with a firm's obligations under Regulation S-P relating to the privacy of customer non-public personal information, FINRA issued a Regulatory Notice to clarify that a firm's obligations under the NTM do not conflict with its obligations under Regulation S-P. The Regulatory Notice states that the NTM does not recommend or suggest that a firm obtain non-public personal information about any customers of a prospective registered representative and that the goal of due diligence pursuant to the NTM is to understand the extent to which any mutual funds and variable products currently held in a prospective registered representative's customer accounts would not be able to be serviced or sold by the successor firm. The Regulatory Notice indicates that detailed non-public personal information about a prospective registered representative's individual customers and their particular investments is not necessary or relevant to meet the objectives of the review recommended by the NTM.

➤ **SEC Staff Issues Reminder Regarding Regulation S-P Privacy Obligations with Respect to Rule 22c-2 Information**

The staff of the SEC's Division of Investment Management sent a letter to the Investment Company Institute asking it to remind its membership that non-public personal information received in response to a request pursuant to a shareholder information agreement designed to comply with Rule 22c-2 under the Investment Company Act of 1940, as amended, may not be used for marketing purposes unless the shareholders whose non-public personal information is provided have been given notice and the opportunity to opt out of this type of information sharing by their financial intermediary. In general terms, Rule 22c-2 requires funds to enter into written agreements with financial intermediaries that hold fund shares on behalf of their customers, under which the intermediaries must agree to provide the funds with certain underlying shareholder identity and transaction information upon request. Under the implementation schedule for Rule 22c-2, funds must be able to request shareholder identity and transaction information beginning October 16, 2007.