

# Financial Services Alert

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***Developments of Note*****➤ Goodwin Procter to Host Webinar: “The Rise of ERISA Litigation and its Impact on Collective Trusts” – 2/7/2008 at Noon (Eastern Standard Time)**

Goodwin Procter will host a free one hour webinar at noon (EST) on February 7, 2008 that will address the recent waves of ERISA litigation and related regulatory investigations – particularly those involving collective trusts and allegations of excessive fees charged by service providers, in addition to “stock drop” cases (as discussed in the December 25, 2007 and January 1, 2008 *Alerts*). Goodwin Procter litigators will also share their views on the trends of these areas of litigation and discuss steps that financial service firms can take now to prevent, or at least defend against, these kinds of regulatory investigation or litigation.

- Hosted by Gregory Lyons, Chair, Goodwin Procter Financial Services practice group
- Speakers include Goodwin Procter partners Jack Cleary, Daniel Condon, James Dittmar and James Fleckner

As of today, approximately 275 participants have registered for the webinar. Register by clicking [here](#).

## ➤ Money Services Firm Pays in Excess of \$20 Million for Anti-Money Laundering Program Deficiency

Sigue Corp. (“Sigue”), a California-based money services business, agreed to settle a civil money penalty action brought by the U.S. Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”) and concurrently entered into a one-year deferred prosecution agreement with the Department of Justice. In so doing, Sigue did not admit to any wrongdoing, but agreed to pay in excess of \$20 million to the U.S. government for asserted violations of the Bank Secrecy Act (“BSA”).

The Sigue case, as with the many high-profile BSA enforcement cases that have preceded it, highlights again the risks of having a deficient anti-money laundering program. The enforcement action also may again make bankers wary of doing business with money transmitters; many banks have discontinued transactions with money services businesses for fear of the exposure of such businesses to money laundering risks, and the Sigue enforcement action may continue and accelerate the trend. Finally, some have suggested that the Justice Department’s action and, in particular, its citation that Sigue failed to “prevent” money laundering may signal that financial institutions are being held to a new, higher BSA standard – one that not only requires financial services firms to detect and report money laundering and criminal activities, but also to take more affirmative steps to prevent such activities.

The Sigue enforcement action arose because, from November 2003 through June 2006, Sigue’s anti-money laundering program was allegedly deficient in each of its four required core elements. Specifically, according to FinCEN, Sigue lacked effective anti-money laundering controls, did not have adequate compliance personnel, and had insufficient training and testing. FinCEN called Sigue’s BSA compliance failures “serious, longstanding and systemic” and stated that these failures resulted in Sigue’s failure to apprehend “continued patterns of suspicious activity, with repeated common characteristics.”

In terms of internal controls, FinCEN asserted that Sigue’s transaction monitoring system was not commensurate with the volume, dollar amounts, and geographic reach of the company’s transactions. The company also allegedly failed to conduct timely reviews of transactions and neglected to investigate and prevent misuse of its business by criminals. As a result, FinCEN found that 47 Sigue agents had assisted remitters to structure transactions to avoid BSA reporting requirements. The Justice Department also asserted that, although Sigue filed suspicious activity reports on “obviously structured transactions,” the company failed to identify “broader patterns of money laundering activity and prevent the unlawful activity from continuing.”

These deficiencies were coupled with other alleged problems. FinCEN noted, for example, that there were insufficient numbers of compliance personnel for Sigue’s operations and that the roles, responsibilities, and oversight of the compliance function were not adequately defined. Similarly, FinCEN found Sigue’s training program generally to be inadequate and, in some cases, training was neither completed nor documented. The testing function also was lacking, according to FinCEN. Specifically, FinCEN determined that audits were not tailored to test and capture compliance for certain BSA requirements, particularly involving high-risk agents.

## ➤ FinCEN Releases New Interpretation of the Term “Correspondent Account” for Purposes of Section 312 of the Patriot Act

The Financial Crimes Enforcement Network (“FinCEN”) issued interpretive guidance regarding the term “correspondent account” for purposes of Section 312 of the Patriot Act (“Section 312”). Specifically, FinCEN’s guidance clarifies that the presentation of a negotiable instrument for payment by a U.S. covered financial institution to a foreign financial institution does not establish a “correspondent account” and does not trigger the due diligence requirements of Section 312.

Under Section 312, U.S. covered financial institutions – including banks, securities broker-dealers, and others – must conduct certain due diligence when establishing correspondent accounts for foreign financial institutions. Such diligence must be risk-based and on-going over the term of the correspondent account.

FinCEN's guidance addresses whether Section 312's due diligence requirements apply when a covered financial institution receives a negotiable instrument, such as a check or draft, from one of its customers for presentment to a foreign financial institution. The guidance clarifies that the "transaction-by-transaction presentation" of negotiable instruments to foreign paying institutions does not establish a correspondent account for purposes of the due diligence requirements of Section 312. Importantly, FinCEN states that the result does not differ "[r]egardless of the volume or frequency" with which a covered financial institution may present negotiable instruments to a particular foreign financial institution for payment.

### ➤ OCIE Director Discusses Frequently Asked Questions about SEC Examinations

At a recent SIFMA Compliance and Legal Division Luncheon, Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), provided answers to frequently asked questions about SEC examinations. She noted that she would be addressing "top 10" compliance issues at the annual meeting of the Legal and Compliance Division. Ms. Richards' questions and answers are summarized below.

- Will my firm be examined?

Ms. Richards indicated that OCIE focuses on firms that fall in the following categories:

- > firms whose size is such that any problems may affect a significant number of investors
- > firms and areas within firms whose compliance controls or supervision appear to be weak, as indicated by, for example, prior examination or enforcement history
- > firms involved in activities that may present increased compliance risk

- What issues are SEC examiners focused on now?

*Controls Over Valuation.* Ms. Richards indicated that OCIE examiners are focusing on valuation processes and controls with a particular emphasis on difficult-to-price securities such as structured products and illiquid securities. Examiners will look at a firm's processes and procedures for risk management, valuation, accounting and other back office functions to determine whether they are adequate given the types of investments the firm is making. In this process, she noted that examiners are likely to want to understand the level of experience and sophistication of the personnel involved in pricing and whether there is some level of independence in the pricing process. She added that controls over the pricing of illiquid securities were a particular focus with examiners looking at whether prices were calibrated to absorb all trade data and whether dealer quotes used in the pricing process reflect prices at which a security could actually be sold.

*Controls over Non-Public Information.* Ms. Richardson indicated that OCIE regards insider trading as a high priority for all types of entities – broker-dealers, advisers and funds. Examiners will focus on whether a firm has identified the source and type of non-public information that it and its employees may be privy to, whether the firm has created and implemented adequate procedures to maintain the confidentiality of that information and how firms ensure their procedures are working, *e.g.*, what kind of testing is being performed.

*Senior Investors.* Ms. Richards indicated that the SEC has prioritized the protection of senior investors not only in its examination program, but also in the areas of investor education and enforcement. OCIE will be interested in understanding the practices that firms are developing in the following areas:

- > marketing and advertising to seniors
- > account opening
- > product and account suitability
- > ongoing review of the relationship and suitability of products

- > discerning the changing needs of seniors
- > surveillance and compliance reviews
- > training for firm employees

- What kind of information and documents are examiners likely to request

Ms. Richards indicated that although it would not comply with requests from compliance consultants and firms that OCIE follow a standard document request for examinations, OCIE was looking for ways to be more transparent in the kinds of documents and information that examiners frequently need. Ms. Richards urged firms to feel comfortable speaking with examination teams about the documents that the firms maintain and the relative ease or difficulty in providing information requested; she indicated this dialogue was important to ensure that examiners obtained the information they need, and in a way that minimizes disruption to the firm to the extent possible.

- What are the possible outcomes of an examination?

Following a brief discussion of the non-public deficiency letters provided at the conclusion of most examinations, Ms. Richards listed the following criteria as being among those used by OCIE to determine whether to make an enforcement referral:

- > Does it appear that fraud has occurred?
- > Were investors harmed?
- > If the conduct does not include fraud, is it serious (*i.e.*, on-going, repetitive, systemic or severe)?
- > Did the firm apprise the SEC of the conduct and take meaningful corrective action?
- > Is the conduct of a type/degree more appropriately handled by the SEC, as opposed to another regulator.
- > Is the activity in a particular area that the SEC wants to emphasize (*i.e.*, emerging types of wrongdoing)?
- > Did the actor profit from the conduct?
- > Did the actor appear to act intentionally?
- > Is the conduct recidivist in nature?
- > Were the firm's supervisory procedures inadequate?

- What can compliance staff do to ensure the examination goes smoothly?

Ms. Richards urged firms to assume they will be examined and to treat regulatory examinations as a normal part of their business as a responsible regulated firm. She noted that a very common exam finding is that firms have inadequate written policies and procedures for the nature of their business and their particular compliance risk, or do not implement those they do have. She suggested firms begin their preparation with this issue. She cautioned that firms should not, however, run their compliance programs around the regulatory exam process, *i.e.*, by focusing on areas of known regulatory concern immediately before any examination, an approach she suggested would be obvious to OCIE examiners. Ms. Richards indicated that firms should provide examiners with accurate, responsible information in a timely way and that firm employees should be educated to do so. Firms should discuss ground rules for an examination at the outset, for example, determining who will be the firm's contact person, resolving any questions about the OCIE's document request and establishing examination priorities. She cautioned that firms should avoid accidental destruction of documents after being notified of an examination. Ms. Richards urged firms to communicate with examiners, and in doing so, to be scrupulously honest with them and discuss a firm's operations openly, using examiner questions as an opportunity to explain a

firm, its business, its compliance risks and corresponding compliance controls. Ms. Richards indicated that if a firm becomes aware of a problem during an examination or decides to address a compliance problem being examined during an examination, it should communicate with the examination team.

➤ **FRB-Kansas City Issues Research Study Concluding That Shareholders of Banking Company Targets in Merger Transactions Obtain Highest Premiums When the Target's Board has a High Proportion of Outside Directors**

The Federal Reserve Bank of Kansas City issued a research study entitled *Target's Corporate Governance and Bank Merger Payoffs* (the "Study") that concludes, based upon a study of bank mergers from 1990 through 2004, that independent outside directors of banking companies are more likely than inside directors to make decisions regarding merger transactions that are consistent with shareholder wealth maximization. The Study found that purchase premiums for banking company targets with a higher proportion of outside directors were higher than purchase premiums for targets with a relatively higher proportion of inside directors. The results of the Study also support the proposition that where a banking company's board includes a high percentage of insiders, the acquisition premium will be lower because the insiders have an inherent conflict of interest and are susceptible to trading shareholder gains "in return for their own personal benefits, such as job security and other employment-related perquisites." The authors of the Study stress that the benefit to shareholders of having a board with a high percentage of outside independent directors evidenced in the banking sector is consistent with the results of their analysis of boards of non-financial firms.

➤ **Mutual Funds Denied No-Action Relief to Exclude Shareholder Proxy Proposal Seeking Adoption of Procedures to Screen Out Investments Based on Ethical Criteria**

The staff of the SEC's Division of Investment Management (the "staff") denied no-action relief to certain affiliated mutual funds seeking to omit the following shareholder proposal from the proxy materials for their upcoming shareholder meetings:

"RESOLVED: In order to ensure that [the investment company] is an ethically managed company that respects the spirit of international law and is a responsible member of society, shareholders request that the [investment company's] Board institute oversight procedures to screen out investments in companies that, in the judgment of the Board, substantially contribute to genocide, patterns of extraordinary and egregious violations of human rights, or crimes against humanity."

The funds sought to exclude the proposal on two grounds pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, as amended. The funds first sought to exclude the proposal under Rule 14a-8(i)(7), which permits omission of a proposal if the proposal deals with a matter relating to the investment company's ordinary business operations. Specifically, the funds argued that the proposal would interfere with the fund's ordinary business operations because it touched on the central function of their day-to-day management, the selection of securities, as opposed to any broad or fundamental corporate policy. The funds also asserted that the proposal was not within the exception to the Rule 14a-8(i)(4) exclusion recognized by the staff for proposals that raise significant social policy issues.

The funds also cited Rule 14a-8(i)(3), which allows an issuer to exclude a proposal that violates any of the proxy rules including the general anti-fraud provisions of Rule 14a-9, as additional grounds for excluding the proposal. The funds argued that the supporting statement for shareholder proposal included statements directly or directly impugning character, integrity or personal reputation or directly or indirectly making charges concerning improper, illegal or immoral conduct or association, without factual foundation – a basis for excluding a proxy proposal under Rule 14a-8(i)(3) recognized by the staff in the past. The funds also argued that the proposal was misleading in violation of Rule 14a-9 because of its vagueness: (a) the proposal used the term "screen out," which could be interpreted to mean that the screening procedures must address future investments or could be interpreted to also

include divestment of existing holdings that fail the screening standards, and (b) the proposal did not provide an appropriate mechanism for each fund's board to determine the standard against which companies would be judged, therefore making it difficult for shareholders to know what actions would result from their vote on the proposal.

The staff gave no reasons for its denial of no-action relief.

### ➤ **OTS Approves Private Equity Fund's Rebuttal of Control and Concerted Action Regarding a Thrift**

The OTS issued an Order (#2008-01) approving a Rebuttal of Control and Concerted Action filed by a private equity fund and affiliated entities and individuals (the "Acquiror"). OTS Control Regulations state that an acquiror is deemed, subject to rebuttal, to have acquired control of a federal savings association if the acquiror, directly or indirectly, acquires more than ten percent of any class of voting stock of a savings association and is subject to any control factor. The Acquiror here sought to acquire up to 25% of the stock of a thrift (the "Target"), and filed a rebuttal of control setting forth the facts and circumstances in support of its contention that no control relationship exists between the Acquiror and the Target. The standard rebuttal agreement provides that a rebutting party will not engage in any intercompany transactions with the entity or the affiliates of the entity for which they are rebutting control. The Rebuttal of Control filed by the Acquiror sought approval for engaging in certain limited transactions with the Target and participating as a party to certain agreements with the Target. After review of the nature and extent of the proposed transactions and specified types of agreements, the OTS ruled that the Acquiror did not have the ability to control or influence the Target. The standard rebuttal agreement also provides that an acquirer may not seek or accept non-public information from the subject of the rebuttal of control agreement. The Acquiror represented that it would not seek or accept material non-public information, though it would occasionally exchange immaterial non-public information with the target due to the nature of its investment advisory business. The OTS concluded that because the information was not material and similar to that exchanged between other investment advisors and their clients, this modification did not contravene the purposes of the rebuttal agreement.

As to the rebuttal of concerted action, parties seek to rebut (1) the presumption that a person will be acting in concert with members of the person's immediate family, or (2) that a company is acting in concert with a management official of a company, if both the company and the person own stock in the savings association or savings and loan holding company. Two affiliated individuals of the Acquiror received approval for their rebuttals of concerted action after demonstrating that: (1) the controlling member of the Acquiror, and his wife and children, did not own any voting stock in the Target, and the controlling member had executed an affidavit asserting he would not act in concert with his immediate family members and (2) a management official of the Acquiror personally owned a de minimis amount of the Target's common stock, and executed an affidavit representing that he would not act in concert with the Acquiror. On the basis of these facts, OTS found that the Rebuttals of Concerted Action met the applicable approval standards.

## *Other Items of Note*

### ➤ **SIFMA Publishes White Paper on Best Execution Guidelines for Fixed-Income Securities**

The Asset Management Group ("AMG") of the Securities Industry and Financial Markets Association ("SIFMA"), released a white paper designed to provide guidance regarding achieving best execution for fixed-income securities. The white paper discusses the dearth of guidance on providing best execution for fixed-income securities in contrast to that for equity securities, and discusses differences between the two markets that have a bearing on best execution determinations in the fixed-income securities context. The centerpiece of the white paper are the Best Execution Guidelines for Fixed-Income Securities (the "Guidelines") which are described as representing a synthesis of the practices and experience of a number of the AMG's member firms. The white paper does not address transactions in

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derivatives, guidance articulated by regulators outside the U.S. regarding fixed-income best execution and transactions involving clients subject to ERISA.

**➤ SEC Approves FINRA Proposal to Delay Effective Date for Principal Review and Approval Provisions of New Variable Annuity Sales Rule**

The SEC approved FINRA's proposal to delay from May 5, 2008 until August 4, 2008 the effective date of paragraph (c) of Rule 2821, which addresses principal review and approval of sales and exchanges of deferred variable annuities. (New Rule 2821's requirements were summarized in the September 18, 2007 *Alert*.) In response to industry comment, FINRA's staff has indicated that it intends to give further consideration to paragraph (c) of Rule 2821 and related interpretive statements in Regulatory Notice 07-52, which announced SEC approval of the rule, to determine whether certain unintended and harmful consequences might ensue if the rule went into effect as originally planned. If, based on this review, FINRA concludes that further rulemaking is warranted, it will file a separate rule change with the SEC.