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DEVELOPMENTS OF NOTE

The FRB Proposes Guidance on Incentive Compensation Practices

On October 22, 2009, the FRB issued [proposed guidance](#) and announced two initiatives relating to the incentive compensation policies and practices of banking organizations under the FRB's supervision. The FRB's release (1) sets forth a set of principles designed to ensure that banking organizations' incentive compensation practices do not undermine the safety and soundness of such organizations or encourage excessive risk taking, and (2) announces the following two new FRB supervisory initiatives:

- a special "horizontal review" of the incentive compensation practices at 28 large complex banking organizations ("LCBOs"); and
- a review of incentive compensation practices at smaller regional, community and other banking organizations not classified as LCBOs, as part of a regular risk-focused examination process.

The FRB did not name the 28 LCBOs subject to the “horizontal review.” The proposed guidance explains the FRB’s expectation that each LCBO will cooperate with the compensation review and work closely with the FRB to evaluate its incentive compensation practices. Such cooperation includes providing the FRB with information and documents clearly describing the LCBO’s existing incentive compensation arrangements, processes and plans and all related risk-management controls and practices. The FRB will supervise each LCBO to make certain that results of the review are implemented in a timely manner, and the FRB may take enforcement actions against non-compliant organizations. For non-LCBO’s, the FRB’s review will be tailored to reflect the complexity and scope of the organization’s activities and compensation arrangements.

Within the release, the FRB also sets out and explains three guiding principles for incentive compensation arrangements at banking organizations. Such arrangements should:

- provide employees with incentives that do not encourage risk-taking behavior in excess of the banking organization’s ability to identify and manage risk effectively and that effectively balance risk-taking incentives;
- be compatible with an organization’s effective controls and risk management; and
- be supported by strong corporate governance practices, including active and effective oversight by the board of directors (or compensation committee, as appropriate).

The FRB will conduct the reviews discussed above and make recommendations in accordance with these guiding principles. The proposed guidance and review initiatives will apply to incentive compensation arrangements for the following employees:

- senior executives and other employees with responsibility for oversight of the organization’s firm-wide activities or material business lines;
- individual employees whose activities may expose the organization to material risks; and
- groups of employees with the same or similar incentive compensation arrangements that, in the aggregate, could expose the organization to material risk.

The proposed guidance will become effective 30 days after its publication in the *Federal Register*. In a related Q & A, the FRB also explained that it does not favor a pay cap or other “one size fits all” approaches for its the organizations over which it has supervisory authority.

House Financial Services Committee Passes the Consumer Financial Protection Act of 2009

The House Financial Services Committee approved by a 39-29 vote the Consumer Financial Protection Agency Act of 2009 (the “CFPA Act”), which consolidates federal consumer protection for financial matters in a new federal agency, the Consumer Financial Protection Agency (“CFPA”). For our previous coverage of the CFPA Act, please see the [October 20, 2009 Alert](#) and the [August 4, 2009 Alert](#).

The House Financial Services Committee approved several amendments before voting on the entire bill. These included a significant amendment offered by Reps. Mel Watt and Dennis Moore (the “Watt-Moore Amendment”) that would make national banks and federally chartered savings associations subject to a broad range of state consumer protection and financial services laws. The Watt-Moore Amendment would, in all but a few cases, make “state consumer financial laws” applicable to national banks and thrifts, as well as their subsidiaries and affiliates. The Watt-Moore Amendment codifies the standard in *Barnett Bank v. Nelson*, 517 U.S. 25 (1996). This standard permits a federal banking agency to preempt state consumer financial protection laws only after a written finding that the state law “prevents or significantly interferes” with a federally-chartered bank or thrift’s exercise of a power “explicitly” granted by Congress. The finding must be done by regulation or order on a case-by-case basis. The federal banking agencies would also be required to consult with CFPB to determine that consumers will still be protected under federal law if the state law is preempted. The Watt-Moore Amendment would allow judges reviewing preemption decisions to defer to the OCC on its interpretation of the National Bank Act or other federal laws. However, judges could not defer to the OCC on a specific claim by the OCC that a particular state law is preempted.

The final version of the CFPB Act passed by the House Financial Services Committee also grants far more expansive powers to the Director of the CFPB than contained in the original draft of the bill. For example, the Director of the CFPB would have the power to exempt any entity regulated by the CFPB and any financial product or service from a consumer law or regulation.

Compliance with SEC Affiliate Marketing Rules for Broker-Dealers, Investment Advisers, Transfer Agents and Investment Companies Required Beginning January 1, 2010

The SEC approved a final rule on affiliate marketing, implementing Section 214 of the Fair and Accurate Credit Transactions Act of 2003 (“FACTA”), which amends the Fair Credit Reporting Act. Section 214 of FACTA provides consumers with the right to restrict a person from using certain information obtained from an affiliate to make solicitations to that consumer. The new rule, which applies to broker-dealers (other than notice registered broker-dealers), investment companies and SEC-registered investment advisers and transfer agents, has a January 1, 2010 compliance date.

FACTA required the federal banking regulatory agencies (the “Agencies”), the Federal Trade Commission (the “FTC”) and the SEC, in consultation and coordination with one another, to issue rules on affiliate marketing. The FTC issued its final affiliate marketing rules on October 30, 2007 (the “FTC Rules”), and the Agencies released joint final rules on November 7, 2007 (the “Joint Rules”). After submitting rules for comment on July 8, 2004, the SEC adopted a final set of rules (“Regulation S-AM”) governing affiliate marketing to be codified at 17 CFR 248.101 *et seq.*

Regulation S-AM mirrors the requirements that have been introduced by the FTC and the Agencies. Generally, the rule will require that consumers be provided an opportunity to “opt-out” before a person or company may use “eligibility information” provided by an affiliated company to market its products or services to the consumer. Regulation S-AM defines “eligibility information,” by reference to the statute, as:

- (1) any report containing information solely as to transactions or experiences between the consumer and the person making the report that is communicated among persons related by common ownership or affiliated by corporate control; or
- (2) certain other information about the consumer that has been communicated among persons related by common ownership or affiliated by corporate control, if certain opt out conditions have been met.

Regulation S-AM does not cover aggregate or blind data that does not contain personal identifiers such as account numbers, names or addresses.

Regulation S-AM places conditions on the use of certain information received from an affiliate to make a marketing solicitation to a consumer. It is important to note that what constitutes a marketing solicitation for the purposes of Regulation S-AM is quite different from a solicitation under the securities laws. Under the definition of “marketing solicitation” under Regulation S-AM:

- A marketing solicitation generally includes any communication that is based on eligibility information provided by an affiliate, and intended to encourage the consumer to purchase or obtain the product or service.
- General advertising directed at the general public such as television, magazine or billboard advertising is excluded from the definition of marketing solicitation for this purpose.
- However, other types of marketing, such as educational seminars, customer appreciation events, and similar forms of communication may be marketing solicitations, and will be evaluated based on the specific facts and circumstances of each occurrence.

It is important to note that Regulation S-AM does not bar information sharing between affiliates, nor does it bar an affiliate’s use of customer information that it has collected itself in the scope of its business relationship with the customer. Regulation S-AM does limit the use of shared customer information for marketing purposes. Therefore, a covered institution makes a marketing solicitation if it:

- accesses or receives information from an affiliate about a consumer;
- uses that information to identify a target customer or type of consumer, establishes criteria used to select customers, or tailors products offered to a particular customer; and
- provides a marketing solicitation to that identified customer.

This general prohibition on marketing solicitations applies unless the following three conditions are met:

- it must be clearly and conspicuously disclosed to the consumer in writing or, if the consumer agrees, electronically, in a concise notice that the person may use shared eligibility information to make solicitations to the consumer;

- the consumer must be provided a reasonable opportunity and a reasonable and simple method to opt out of the use of that eligibility information to make solicitations to the consumer; and
- the consumer must not have opted out.

The notice must be provided by an affiliate who has an existing business relationship with the customer, or as part of a joint notice from two or more members of an affiliated group of companies, provided that at least one of the affiliates on the joint notice has an existing business relationship with the consumer. An appendix to the final rule contains model forms that companies may elect to use in order to facilitate compliance with the notice and opt-out requirements of the new rule.

One notable exception to general affiliate marketing requirement is the concept of “constructive sharing.” The SEC noted in the preamble to the final rule that constructive sharing arrangements, where an entity with an established relationship with a consumer uses eligibility information to market products or services on behalf of an affiliated entity, are outside the scope of the affiliate marketing rule. Under Regulation S-AM, if an entity accesses or receives information from an affiliate about a consumer, uses that information to identify a target customer, and provides a marketing solicitation to that identified customer, the entity would normally have to comply with the opt out rules discussed above. However, in constructive sharing, the entity with whom the consumer has an established relationship can make the solicitation on behalf of the affiliate, and need not provide opt out notice. In addition, that entity may direct a service provider to use the entity’s own eligibility information to market products on behalf of an affiliate as well. The SEC provided the following example of constructive sharing in the release adopting Regulation S-AM: “a broker-dealer that sells investment company shares to a consumer has a pre-existing business relationship with the consumer (as does the investment company if the consumer is the record owner of its shares). The broker-dealer may make a marketing solicitation for an investment in an affiliated investment company based on eligibility information the broker-dealer obtained in connection with its pre-existing business relationship with the consumer.”

The SEC rule largely mirrors the substantive provisions of both the FTC Rule and the Joint Rules. In fact, most of the operating language in Regulation S-AM is the same as the language in the FTC Rule. Although the FTC Rule has additional and/or different examples and explanations, the requirements are identical.

A minor difference between Regulation S-AM and the Joint Rules and FTC Rule is that the Joint Rules and the FTC Rule provide that compliance with an example described in the rules constitutes compliance. The SEC has stated that its examples do not provide the same safe harbor. The SEC examples in Regulation S-AM are intended to describe the broad outlines of situations illustrating compliance with the applicable rule. However, the SEC believes that the specific facts and circumstances relating to a particular situation will determine whether compliance with an example constitutes compliance with the rules.

FINRA Files Proposed Rule Changes Covering Marketing Materials for Variable Products

FINRA filed with the SEC proposed rule changes regarding marketing material for variable annuities and variable life insurance (collectively, “variable products”). FINRA proposes to

adopt new FINRA Rule 2211 as a replacement for current NASD Interpretive Material 2210-2 (IM-2210-2). The proposed new rule reflects FINRA's response to comments filed after FINRA's initial publication of proposed changes in Regulatory Notice 08-39 (as discussed in the [August 5, 2008 Alert](#)).

New FINRA Rule 2211 modifies some of the existing requirements of IM-2210-2 and codifies some of the FINRA staff interpretations that have developed through the advertising filing program since IM-2210-2 was adopted in 1993. New Rule 2211 would also add new provisions regarding riders. For example, the new rule would require that any communication discussing a guaranteed amount, benefit base or similar contract accumulation value that is not available for withdrawal in cash must clearly disclose that the value is not available in cash or, if applicable, the restrictions to and reductions taken when receiving such value if cash. In addition, communications regarding riders would be required to explain costs and limitations of those riders. New Rule 2211 would also provide detailed guidance regarding both hypothetical and historical illustrations. In response to comments, FINRA clarified that the rules do not expand prospectus delivery obligations and determined not to require use of guaranteed maximum charges in certain historical performance illustrations. If the SEC determines to move forward with this proposal, the next step would be the publication of the proposed changes in the *Federal Register* for public comment.

FDIC Approves Final Rule to Phase Out the Debt Guarantee Component of the Temporary Liquidity Guarantee Program

The FDIC approved a [final rule](#) (the "Final Rule") to phase out the Debt Guarantee Program (the "DGP") of the Temporary Liquidity Guarantee Program (the "TLGP"). In October 2008, the FDIC adopted the TLGP as part of a coordinated effort by the FDIC and other federal agencies to address disruptions in credit markets and the resultant inability of financial institutions to obtain funding and make loans to creditworthy borrowers. For more on the TLGP generally, please see the [October 14, 2008 Alert](#) and the [November 25, 2008 Alert](#). The FDIC had previously extended the DGP for four months, and recently extended the Transaction Account Guarantee Program of the TLGP for six months. For further discussion on the previous extension of the DGP, please see the [February 17, 2009 Alert](#); and for further discussion on the extension of the Transaction Account Guarantee Program please see the [September 1, 2009 Alert](#).

To ensure an orderly phase-out of the DGP, the FDIC is establishing a limited emergency guarantee facility. For most insured depository institutions and other entities participating in the DGP, the program will conclude on October 31, 2009, with the FDIC's guarantee expiring no later than December 31, 2012. To the extent that certain of those entities become unable to issue non-guaranteed debt to replace maturing senior unsecured debt because of market disruptions or other circumstances beyond their control, an emergency guarantee facility will be available on an application basis to insured depository institutions participating in the DGP and any other entities that have issued FDIC-guaranteed senior unsecured debt by September 9, 2009.

Under the Final Rule, in order to utilize the emergency guarantee facility, an entity must apply to, and receive prior approval from, the FDIC. The FDIC established a high application threshold for the emergency guarantee facility. To use the emergency guarantee facility, applicants would be required to demonstrate their inability to issue non-guaranteed

debt or to replace maturing debt as a result of market disruptions or other circumstances beyond their control. An applicant is required to submit a projection of its sources and uses of funds through December 31, 2012, a summary of its contingency plans, a description of any collateral that it can make available to secure its obligation to reimburse the FDIC for any payments made pursuant to the guarantee, a description of its plans for retirement of the FDIC-guaranteed debt, a description of the market disruptions or other circumstances beyond its control that prevent it from replacing maturing debt with non-guaranteed debt, a description of management's efforts to mitigate the effects of such disruptions or circumstances, conclusive evidence that demonstrates its inability to issue non-guaranteed debt and any other relevant information that the FDIC deems appropriate.

If the application is approved, the FDIC will guarantee the applicant's senior unsecured debt issued on or before April 30, 2010. The FDIC's guarantee under the emergency guarantee facility would expire no later than December 31, 2012. Participation in the emergency guarantee facility would be very expensive for the participating institution. Debt guaranteed under the emergency guarantee facility will be subject to an annualized assessment rate equal to a minimum of 300 basis points.

European Commission Issues Communication on Strengthening the Derivatives Markets

On October 20, 2009, the European Commission published a [Communication](#), along with related [FAQs](#), on strengthening regulation of derivatives markets. In the Communication, which builds on the European Commission's [July Communication](#) and the [G-20 Pittsburgh Leaders' Statement](#), the European Commission calls for a "paradigm shift away from the traditional view that derivatives are financial instruments for professional use and thus only require light-handed regulation." Sharing priorities with U.S. legislators' proposed regulation of U.S. derivatives markets, the European Commission identifies four principal objectives: (i) reduce counterparty credit risk; (ii) reduce operational risk; (iii) increase transparency; and (iv) strengthen market integrity and oversight.

Reduce Counterparty Risk. The European Commission identifies central counterparty ("CCP") clearing as the "main tool" to manage counterparty risk, and it plans to propose legislation mandating central clearing for standardized derivatives through CCPs. CCPs, which are currently regulated at the national level, would be regulated at the European Community level and would be subject to new business conduct rules and risk management standards. The European Commission intends to propose legislation that would heighten collateral requirements by requiring initial and variation margin and imposing capital charges for non-centrally cleared contracts.

Reduce Operational Risk. The European Commission cites the derivatives markets' increased use of standard legal documentation and electronic processing of trades in the Communication. Under the Communication, it commits to "set ambitious European targets, with strict deadlines, for legal- and process-standardisation."

Increase Transparency. All non-centrally cleared derivatives transactions would be required to be reported to trade repositories. The European Securities and Markets Authority (the "ESMA") would be responsible for authorizing and regulating trade repositories, which would be subject to new authorization, registration, disclosure, and governance requirements. The ESMA also would be responsible for authorizing the operation of third-country repositories in the European Union. Furthermore, all

standardized over-the-counter derivatives contracts would be traded on exchanges or electronic trading platforms. The European Commission also will consider “harmonising” pre- and post-trade transparency requirements for the publication of trades and associated prices and volumes.

Strengthen Market Integrity and Oversight. On April 20, 2009, the European Commission issued a [call for evidence](#) on its review of the Market Abuse Directive, which prohibits insider trading, market manipulation and other abusive behavior. In the Communication, the European Commission states that the review of the Market Abuse Directive in 2010 “will extend relevant provisions in order to cover derivatives markets in a comprehensive fashion.” The European Commission also intends to enable regulators to set position limits “to counter disproportionate price movements or concentrations of speculative positions.”

House Agriculture Committee Proposes New Regulatory Scheme for Over-the-Counter Derivatives Markets

On October 21, 2009, the House Agriculture Committee approved the “Derivatives Markets Transparency & Accountability Act” (the “Agriculture Committee Bill”) as an amendment in the nature of a substitute for the “Over-the-Counter Derivatives Market Act of 2009” approved by the House Financial Services Committee on October 15, 2009. The Agriculture Committee Bill was first introduced on October 16, 2009 by Agriculture Committee Chairman Collin C. Peterson and is based on the Treasury’s proposed derivatives legislation issued in August 2009, which was discussed in Goodwin Procter’s [August 27, 2009 Client Alert](#). The Agriculture Committee’s proposal also incorporates elements from its earlier bill (H.R. 977) approved by the Agriculture Committee in February 2009. Under the Agriculture Committee’s proposal, sweeping additions to the Commodity Exchange Act and the Securities Exchange Act would create an entirely new regulatory regime for derivatives market.

Obama Administration Announces New Program for TARP Funds That Will be Provided to Community Banks to Encourage Small Business Lending

The Obama Administration announced an initiative to encourage small business lending by providing capital support to community banks. Under the plan, community banks with less than \$1 billion in assets will be given access to lower-cost capital, provided that they submit a plan explaining how the capital will allow them to increase lending to small businesses. Participants would also be required to submit quarterly reports detailing their small business lending activities. Banks will be eligible to receive capital totaling up to 2% of risk-weighted assets. The capital would be available at an initial dividend rate of 3%, compared to the Capital Purchase Program’s (the “CPP”) 5%, with the dividend rate increasing to 9% after five years to encourage timely repayment. A bank’s participation will be subject to approval by its primary federal banking regulator. Final details on the terms of the program -- including the amount of capital available and how current CPP participants could replace existing capital with investments under this program -- will be developed in the coming weeks by the Treasury in consultation with community banks and small businesses.

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OTHER ITEM OF NOTE

Senior Supervisors for Seven Countries Issue Report on Risk Management Practices in the Aftermath of the Banking Crises of 2008

The Senior Supervisors Group, senior financial services supervisors from seven countries (Canada, France, Germany, Japan, Switzerland, the United Kingdom and the United States) issued a report (the “SSG Report”) entitled “*Risk Management Lessons from the Global Banking Crisis of 2008.*” The SSG Report first discusses the funding and liquidity issues that were key elements of the banking crisis. The balance of the SSG Report, based in part upon self-assessments of their risk management practices performed by 20 major global financial services companies, discusses important areas in which global financial institutions’ risk management requires continued improvement: (1) board director and senior management oversight; (2) articulating risk appetite; (3) compensation practices, (4) information technology infrastructure; (5) risk aggregation and concentration identification; (6) stress testing; (7) counterparty risk management; (8) valuation practices and loss recognition; (9) operations and market infrastructure; and (10) liquidity risk management.