

# FINANCIAL SERVICES ALERT

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## DEVELOPMENTS OF NOTE

### **FDIC's Board Approves Issuance of ANPR Seeking Public Comment on Whether to Incorporate Risks Related to Compensation Programs into Risk-Based Deposit Insurance Assessment System**

The FDIC's Board of Directors, by a 3-to-2 vote, approved the issuance of an advance notice of proposed rulemaking ("ANPR") concerning whether an insured depository institution ("IDI") compensation program should be incorporated as a factor into the FDIC's determination of the risk-based deposit insurance premium to be charged to the IDI. The FDIC requested public comment on the ANPR and posed 15 specific questions for comment that are noted below. Under Section 7 of the Federal Deposit Insurance Act, the FDIC is supposed to establish a risk-based assessment system for IDIs that incorporates the factors the FDIC believes are relevant in assessing the probability that the Deposit Insurance Fund ("DIF") will incur a loss because of an IDI. The FDIC states in the ANPR that it has concluded that IDI compensation practices led to excessive risk-taking by IDI management that contributed to the recent financial crisis.

The FDIC stresses in the ANPR that it does not seek to limit compensation of IDIs, but rather it seeks to adjust risk-based deposit insurance assessment rates to adequately compensate the DIF "for the risks inherent in the design of certain compensation programs." The FDIC says that it seeks to provide incentives for IDIs and their holding companies to adopt compensation programs that "align employees' interests with the long-term interests" of the IDI, the FDIC and the IDI's other stockholders. The FDIC also wants to promote the use of compensation programs that reward employees for focusing on

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risk management. The FDIC does not propose specific minimum compensation standards in the ANPR.

The FDIC proposes in the ANPR that IDIs that incorporate three specific criteria into their compensation programs, benefit by being charged lower risk-assessment deposit premiums. The three criteria are:

1. an employee whose business activities present a significant risk to the IDI should have a significant component of his or her compensation paid in restricted non-discounted IDI stock;
2. significant awards in IDI stock should only vest over a multi-year period, with the possibility of a clawback, or other look-back mechanism; and
3. employee compensation programs should be administered by an independent committee of the Board of Directors (with input from independent compensation professionals).

The FDIC requested public comment on all aspects of the ANPR , but in particular requested comments on the following 15 questions:

- “1. Should an adjustment be made to the risk-based assessment rate an institution would otherwise be charged if the institution could/could not attest (subject to verification) that it had a compensation system that included the following elements?
  - a. A significant portion of compensation for employees whose business activities can present significant risk to the institution and who also receive a portion of their compensation according to formulas based on meeting performance goals would be comprised of restricted, non-discounted company stock. The employees affected would include the institution’s senior management, among others. Restricted, non-discounted company stock would be stock that becomes available to the employee at intervals over a period of years. Additionally, the stock would initially be awarded at the closing price in effect on the day of the award.
  - b. Significant awards of company stock would only become vested over a multi-year period and would be subject to a look-back mechanism (e.g., clawback) designed to account for the outcome of risks assumed in earlier periods.
  - c. The compensation program would be administered by a committee of the board composed of independent directors with input from independent compensation professionals.
2. Should the FDIC’s risk-based assessment system reward firms whose compensation programs present lower risk or penalize institutions with programs that present higher risks?

3. How should the FDIC measure and assess whether an institution's board of directors is effectively overseeing the design and implementation of the institution's compensation program?
4. As an alternative to the FDIC's contemplated approach (see q. 1), should the FDIC consider the use of quantifiable measures of compensation—such as ratios of compensation to some specified variable—that relate to the institution's health or performance? If so, what measure(s) and what variables would be appropriate?
5. Should the effort to price the risk posed to the DIF by certain compensation plans be directed only toward larger institutions; institutions that engage only in certain types of activities, such as trading; or should it include all insured depository institutions?
6. How large (that is, how many basis points) would an adjustment to the initial risk-based assessment rate of an institution need to be in order for the FDIC to have an effective influence on compensation practices?
7. Should the criteria used to adjust the FDIC's risk-based assessment rates apply only to the compensation systems of insured depository institutions? Under what circumstances should the criteria also consider the compensation programs of holding companies and affiliates?
8. How should the FDIC's risk-based assessment system be adjusted when an employee is paid by both the insured depository institution and its related holding company or affiliate?
9. Which employees should be subject to the compensation criteria that would be used to adjust the FDIC's risk-based assessment rates? For example, should the compensation criteria be applicable only to executives and those employees who are in a position to place the institution at significant risk? If the criteria should only be applied to certain employees, how would one identify these employees?
10. How should compensation be defined?
11. What mix of current compensation and deferred compensation would best align the interests of employees with the long-term risk of the firm?
12. Employee compensation programs commonly provide for bonus compensation. Should an adjustment be made to risk-based assessment rates if certain bonus compensation practices are followed, such as: awarding guaranteed bonuses; granting bonuses that are greatly disproportionate to regular salary; or paying bonuses all-at-once, which does not allow for deferral or any later modification?
13. For the purpose of aligning an employee's interests with those of the institution, what would be a reasonable period for deferral of the payment of variable or bonus compensation? Is the appropriate deferral period a function of the amount of the award or of the employee's position within the institution (that is, large bonus awards or awards for more senior employees would be subject to greater deferral)?
14. What would be a reasonable vesting period for deferred compensation?

15. Are there other types of executive compensation arrangements that would have a greater potential to align the incentives of employees with those of the firm's other stakeholders, including the FDIC? "

Comptroller of the Currency, John Dugan, who voted against approval of the ANPR, issued a statement explaining that he opposed the issuance of the ANPR for two principal reasons. First, said Comptroller Dugan, the issuance of the ANPR is premature because Congress is considering legislation and the FRB has developed supervisory guidance that would cover parent holding companies of IDIs and "it could be very unfortunate to have an end result where [IDIs] – and perhaps their holding companies – were subject to inconsistent compensation" program requirements. Second, Comptroller Dugan stated that he was unconvinced that IDIs' compensation programs were a risk factor related to the "probability that the [DIF] will incur a loss."

The FDIC made it clear in the ANPR that it intends its assessment premium revision to be complementary to supervisory actions taken by the FRB and supervisory standards set by other regulators. Comments on the ANPR are due to the FDIC on or before February 18, 2010.

### **FDIC Issues Revised Questions and Answers on Policy Statement on Qualifications for Failed Bank Acquisitions**

The FDIC issued revised Questions and Answers (the "Q&A") regarding its Final Statement of Policy on Qualifications for Failed Bank Acquisitions (the "Policy Statement"). For more information on the Policy Statement, please see the [August 26, 2009 Alert](#). The Q&A replaces a previous version of the Q&A that was issued by the FDIC in December 2009, but then subsequently withdrawn shortly after its issuance.

The Policy Statement provides that it will not apply to private investors "in partnerships or similar ventures with bank or thrift holding companies or in such holding companies... where the holding company has a *strong majority interest* in the resulting bank or thrift and an established record for successful operation of insured banks or thrifts." (Emphasis added.) With respect to partnerships with existing holding companies, the Q&A provides that a "strong majority interest" in such context means that the private investors may have (1) no more than one-third of the total equity, and (2) no more than one-third of the voting equity, of the partnership or joint venture post acquisition of the failed depository institution. Similarly, with respect to direct investments in an established bank or thrift holding company acquiring a failed depository institution, the Q&A provides that the Policy Statement would not apply provided that the shareholders of the holding company pre-dating the acquisition of the failed bank or thrift hold at least two-thirds of the total equity of the resulting holding company immediately following the acquisition. (Note that while the limitation with respect to partnerships and joint ventures references limits on both total equity and voting equity, the limitation with respect to direct investments references only total equity.) In making the determination of whether either of these exclusions from the Policy Statement is applicable, the Q&A notes that the FDIC will also take into account the impact of any special rights provided to the private investors through covenants, agreements, special voting rights or other similar mechanisms.

The Policy Statement also provides an exception from its applicability to any private investor with 5% or less of the total voting power of an acquired depository institution or its bank or thrift holding company, provided there is no evidence of concerted action among

these investors. However, the Q&A reflects the FDIC's concern that acquisitions will be structured such that all, or substantially all, of the investors will own less than 5% of the voting stock, so that none of the private investors, or the acquired institution, will be subject to the Policy Statement.

Accordingly, the Q&A provides that the FDIC will presume concerted action among such private investors with less than 5% of the voting power of an acquired depository institution or its holding company if, in the aggregate, such investors hold more than two-thirds of the total voting power. This presumption may be rebutted if the investors or placement agent provides sufficient evidence to the FDIC that the investors are not participating in concerted action. The Q&A notes that the determination of whether investors are engaging in concerted action will be based on a "facts and circumstances analysis," and that participation in "widespread offerings" will not generally be considered to be evidence of concerted action by the resulting investors. Furthermore, the Q&A provides eight factors that the FDIC will consider when evaluating whether a presumption of concerted action has been rebutted, including (1) whether each investor was among many potential investors contacted by the bank/thrift or its agent, and each investor reached an independent decision to invest in the bank/thrift, and (2) whether the investor has engaged, or anticipates engaging, as part of a group consisting of substantially the same entities as are shareholders of the bank/thrift, in substantially the same combination of interests, in any additional banking or non-banking activities in the United States.

While many of the specified factors are similar to those that the various federal banking agencies traditionally use in making concerted action determinations, the FDIC will not defer to the applicable primary federal banking regulator's evaluation as to whether investors are acting in concert for purposes of applying the Bank Holding Company Act and the Change in Bank Control Act. Instead, the Q&A provides that the FDIC will "take into account" the views of the primary federal banking regulator in making its own determination for the purpose of applying the Policy Statement. Accordingly, although the presumption of concerted action in structures in which such 5% or less investors hold greater than two-thirds of the total voting power may be rebutted, such structures will nevertheless result in some uncertainty for investors, and therefore may be more difficult to complete.

Finally, the Q&A provides guidance as to how the FDIC will treat non-voting convertible equity interests held by a private investor that holds less than 5% of the voting stock of a depository institution or its holding company. More specifically, non-voting equity interests that are convertible to voting shares at the election of the investor (or any affiliate of the investor), and that are not required to be immediately transferred from such investor's control following such conversion, would be aggregated with the holder's voting stock in determining whether such investor owns 5% or more of the applicable voting stock for purposes of determining the applicability of the Policy Statement.

### **Obama Administration Announces Financial Crisis Responsibility Fee Levied on Large Financial Institutions to Recoup Projected TARP Losses**

President Obama has announced that he will propose a Financial Crisis Responsibility Fee (the "Fee") in his fiscal 2011 budget proposal, which will be released in February 2010. The Fee is designed to repay taxpayers for the "extraordinary assistance" provided to financial and other companies under the Troubled Asset Relief Program (the "TARP") by instituting a levy on the liabilities of the largest financial firms. The President asserted that

many of the largest financial firms contributed to the causes of the financial crisis and benefited from the extraordinary governmental actions taken to stabilize the financial system. “We need our money back, and we’re going to get it,” President Obama said at a White House press conference.

The Fee would only apply to financial firms with more than \$50 billion in consolidated assets. Covered firms would include insured depository institutions, bank holding companies, thrift holding companies, insurance or other companies that own depository institutions or securities broker-dealers as of January 14, 2010 or firms that become one of those types of firms after January 14, 2010. The Fee would cover the liabilities of such financial firms organized in the United States, including U.S. subsidiaries of foreign firms. The operations of U.S. subsidiaries of foreign firms in such covered areas would be consolidated for purposes of the \$50 billion threshold and the administration of the Fee. For U.S. firms, the Fee would apply to all liabilities globally. The Administration expects that approximately 50 firms would be subject to the Fee, including 35 U.S. firms and 10-15 foreign firms. The Administration hopes to work through the G-20 and the Financial Stability Board to encourage other major financial centers to adopt comparable approaches, though no other country has yet signaled a desire to do so.

The Fee would be assessed at 15 basis points of covered liabilities per year. Liabilities subject to the Fee would be calculated by subtracting Tier 1 capital, FDIC-assessed deposits and insurance policy reserves, as applicable, from the covered firm’s total assets. The Administration stated that FDIC-assessed deposits were excluded from covered liabilities because they are a stable source of funding already subject to assessment. The covered liabilities would be reported by a firm’s regulators, but the Fee would be collected by the Internal Revenue Service and contributed to the government’s general fund to reduce the deficit. The Administration stated that it would work with Congress and the regulatory agencies to design protections against the avoidance of the Fee by covered firms.

The Fee would go into effect on June 30, 2010 and would last at least ten years. If the costs of the TARP had not been recouped after ten years, the Fee would continue to be assessed until such costs are recouped in full. After five years, the U.S. Treasury Department (the “Treasury”) would report on the effectiveness of the Fee as well as its progress in repaying projected losses from the TARP. The Administration projects that the Fee would raise approximately \$90 billion over the next ten years, which corresponds with the estimated losses from the TARP projected by the Treasury and the Office of Management and Budget. The Obama Administration, using a more conservative approach, currently projects that the estimated cost of the TARP will be \$117 billion, which would be raised by the Fee after approximately 12 years. If instituted, over sixty percent of the revenues raised by the Fee are expected to be paid by the 10 largest financial firms.

The Fee is being proposed pursuant to section 134 of the Emergency Economic Stabilization Act of 2008, which requires that by 2013 the President propose a plan “that recoups from the financial industry an amount equal to the shortfall in order to ensure that the [TARP] does not add to the deficit or national debt.” The financial services industry has noted that many of the institutions that will be subject to the Fee either never participated in the TARP or have already repaid their TARP funds, with interest, and that the vast majority of losses under the TARP will result from the assistance granted to American International Group Inc., the automotive industry and mortgage modification programs. The financial services industry asserts that it is being unfairly targeted to shoulder the burden of other’s losses. This argument does not appear to carry much weight in the current political climate,

in which politicians are responding to the persistent public outcry over the TARP which has been renewed by reports that the largest financial firms plan to pay record-setting bonuses to their employees this year. “If these companies are in good enough shape to afford massive bonuses, they are surely in good enough shape to afford paying back every penny to taxpayers,” President Obama said. The President also stated that the firms subject to the Fee were recipients or indirect beneficiaries of the assistance provided by the TARP, the Temporary Liquidity Guarantee Program and other programs that provided emergency assistance to limit the impact of the financial crisis. The Fee would also further the Administration’s financial regulatory reform goal to encourage financial institutions to become smaller. House Financial Services Committee Chairman Barney Frank and Senate Banking Committee Chairman Christopher Dodd both support the Fee, as does House Ways and Means Committee Chairman Charles Rangel, whose committee is responsible for drafting the legislation to implement the proposal. Both the financial services industry and congressional Republicans questioned the wisdom of instituting the Fee before the economy has fully recovered, stating that it will prevent large financial firms from increasing their capital. Congressional Republicans also expressed concerns that the Fee would reduce covered institutions’ ability to lend and that the costs of the Fee would ultimately rest with the consumer. The Administration believes that by only subjecting large institutions to the Fee, competition with community institutions may prevent costs from being passed on to consumers.

### **Federal District Court Upholds Arbitration Clause in Investment Advisory Contract**

The U.S. District Court for the District of Minnesota upheld inclusion of a mandatory arbitration clause in an investment advisory contract. An investor who had executed investment services contracts with a registered investment adviser to receive a financial plan and subsequent annual updates to the plan filed a class action suit against the adviser stating various causes of actions under state law and the Investment Advisers Act of 1940 (the “Advisers Act”) based on allegations that the investor never received a financial plan or updates. The adviser moved to compel arbitration under the terms of the agreements executed by the investor, which generally require arbitration of any controversy or claim arising out of or relating to the investment services agreements or their breach, and specifically preclude class action claims against the adviser.

*Standard of Review.* The Court noted the strong federal policy in favor of arbitration expressed in the Federal Arbitration Act, which permits a party to petition a federal district court for an order compelling arbitration of a dispute covered by an agreement to arbitrate. The Court articulated the applicable standard of review as requiring it to determine whether there is a valid agreement to arbitrate between the parties and if so, whether the dispute falls within the scope of that agreement, with any doubts concerning the scope of arbitrable issues to be resolved in favor of arbitration and the party resisting arbitration bearing the burden of proving that the claims at issue are unsuitable for arbitration. The Court found there to be no dispute that each investment services agreement contains an arbitration clause and that the investor’s claims fall within the scope of those arbitration clauses. The investor, however, argued that including the arbitration clause in the investment services agreement was itself improper because (a) the adviser was also a member of the Financial Industry National Regulatory Authority (“FINRA”) whose rules prohibit arbitration of putative class actions, (b) an SEC staff position and Supreme Court precedent prohibit enforcement of the arbitration clause and (c) arbitration does not offer the equitable relief sought by the investor.

*Applicability of FINRA Rules.* The Court rejected the investor's argument that FINRA rules applied to the adviser and prohibited the arbitration clause in question. Pointing to the fact that the adviser was also registered as a broker-dealer and interpreting the investment services agreement to contemplate that the adviser's representatives might buy and sell securities on an investor's behalf and receive related compensation, the investor claimed that FINRA rules applied because the adviser's representatives' interaction with clients included broker-dealer activities triggering the application of FINRA rules. The Court found that the investment services agreement created no binding purchase/sale obligation for either party that would cause the adviser to necessarily act as a broker-dealer in providing investment advice. The Court also noted that the nature of the claims asserted by the investor related to investment advisory activities, which fall outside FINRA's jurisdiction.

*Arbitration Clauses in Investment Advisory Agreements.* The investor also argued that *McEldowney Financial Services*, SEC No-Action Letter (pub. Avail. Oct. 17, 1986) (arbitration clause in advisory agreement should disclose that it does not constitute a waiver of any right provided by the Advisers Act, including the right to choose the forum, whether arbitration or adjudication, in which to seek resolution of disputes) and *Wilko v. Swan*, 346 U.S. 427 (claims under the Securities Act of 1933 were not arbitrable) precluded an investment advisory contract from including a mandatory arbitration clause. Citing *Rodriguez de Quijas v. Shear-son/Am. Express, Inc.*, 490 U.S. 477 (1989), which expressly overruled *Wilko*, the Court held that neither *McEldowney*, which cited *Wilko*, nor *Wilko* precluded compulsory arbitration of the investor's claims.

*Equitable Relief in Arbitration.* The Court also rejected the investor's argument that arbitration should not be compelled because an arbitrator cannot grant the equitable relief sought. The Court noted that the rules of the American Arbitration Association permit equitable relief and that the Supreme Court had rejected similar arguments in *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991).

*Disposition.* The court granted the adviser's motion to compel arbitration and dismissed the investor's complaint without prejudice.

## **SEC Approves Proxy Rule Changes to Require Shareholder Advisory Vote on Executive Compensation of TARP Recipients**

The SEC issued the [adopting release](#) for changes to the proxy rules that require a company that has received financial assistance under the Troubled Asset Relief Program ("TARP") to include a separate shareholder vote to approve the compensation of the company's executives disclosed in the company's proxy materials. The rules apply to proxy materials for an annual (or special meeting in lieu of an annual) meeting for which proxies are solicited regarding an election of directors. The SEC adopted the new requirement pursuant to Section 111(e) of the Emergency Economic Stabilization Act of 2008, as amended by Section 7001 of the American Recovery and Reinvestment Act of 2009. This requirement, which becomes effective February 18, 2010, will apply to a company for as long as its obligation for TARP assistance remains outstanding. The required shareholder vote (a) is not binding on the board of directors of a TARP recipient, (b) will not be construed as overruling a board decision or as creating or implying any additional fiduciary duty by a TARP recipient's board and (c) will not be construed to restrict or limit the ability of shareholders to submit proposals related to executive compensation for inclusion in proxy

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materials. A TARP recipient will not have to file a preliminary proxy statement solely because its proxy statement complies with the new shareholder advisory vote requirement.

**FinCEN Issues Guidance Regarding Address Confidentiality Programs under CIP Rules**

The U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") provided [guidance](#) to financial institutions regarding application of customer identification programs ("CIPs") to customers who have been issued a post office box through a state address confidentiality program ("ACP"). Such programs are offered in 31 states to provide a victim of domestic violence, sexual assault or stalking who wishes to keep his/her physical address confidential with a substitute address.

Under the CIP rules for banks, broker-dealers, and other financial institutions, a financial institution must obtain a street address from each individual customer who opens an account. If the individual customer does not have a residential or business street address, the financial institution may instead accept the street address of the customer's next of kin or *another contact individual*.

Recognizing the importance of ACPs in protecting individuals, FinCEN stated that it will allow a financial institution to treat a person who participates in a state-created ACP as an individual who does not have a street address. In performing its CIP, the financial institution should obtain the street address of the ACP's sponsoring agency, treating that agency as *another contact individual* for the customer opening the account.