

FINANCIAL SERVICES ALERT

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In this Issue:

Developments of Note

- Goodwin Procter Issues Client Alerts on the Effect of the Dodd-Frank Act on Public Companies, the Securities Lending Industry and Regulation of the Derivatives Markets
- SEC Adopts Amendments to Form Adv, Part 2 and Related Advisers Act Rules
- Broad Agreement Reached on Basel III Capital and Liquidity Reform Package
- DOL Issues Interim Final Regulation Regarding Service Provider Fee Disclosure
- House Financial Services Committee Approves Covered Bonds Legislation
- Federal Agencies Issue Final Rules on Mortgage Originator Identification
- SEC Invites Public Comment on SEC Rulemaking and Studies pursuant to Dodd-Frank Act and Announces Procedures for Meetings Between Interested Parties and SEC Staff
- Update on Accredited Investor – Net Worth Threshold Under Securities Act of 1933

DEVELOPMENTS OF NOTE

Goodwin Procter Issues Client Alerts on the Effect of the Dodd-Frank Act on Public Companies, the Securities Lending Industry and Regulation of the Derivatives Markets

- [Dodd-Frank Wall Street Reform and Consumer Protection Act - Public Company Impact](#)
- [Dodd-Frank and Other Developments Affecting the Securities Lending Industry](#)
- [The Wall Street Transparency and Accountability Act of 2010: Regulation of Derivatives Markets](#)

SEC Adopts Amendments to Form Adv, Part 2 and Related Advisers Act Rules

The SEC recently approved amendments (the “Amendments”) to Part 2 of Form ADV, the form that investment advisers (“Advisers”) use to register with the SEC and state securities regulators. Part 2 has typically formed the basis of, and has been used as, an investment adviser’s written disclosure statement, or “brochure,” required by Rule 204-3(a) under the Investment Advisers Act of 1940 (the “Advisers Act”). The Amendments generally

(a) change the form and some of the substance of Form ADV, Part 2, (b) require various supplements to be delivered to new and prospective clients that provide information concerning those individuals at the Adviser who will be providing advisory services to clients, and (c) require Advisers to file part of Part 2 on the Investment Adviser Registration Depository (“IARD”) system, thus making it accessible to investors through the SEC’s website. Advisers currently file only Part 1 of Form ADV through the IARD. The Amendments also amend various SEC rules under the Advisers Act that generally relate to applications to register as an investment adviser with the SEC and Adviser disclosure obligations to clients and prospective clients.

GENERAL

The Amendments, among other things, divide Form ADV, Part 2 into two sections. The first section, Part 2A, includes information about an Adviser and its business, including fees, clients, investment strategies and risks, disciplinary information, other financial industry activities and affiliates. It also includes, as an appendix, information concerning wrap fee programs that are sponsored by the Adviser. As discussed below, Part 2A must also include a summary of material changes with the annual updating amendment. The second section, Part 2B, is intended as a supplement to an Adviser’s brochure, and includes information about the Adviser’s advisory personnel from whom the client receiving the brochure may expect to receive advice.

Amended Form ADV, Part 2 instructs each Adviser to draft its brochure in plain English and in a narrative format. The Adviser also must present specifically identified information in the order proscribed by amended Form ADV, Part 2, using the headings provided by the form. If an item is inapplicable to the Adviser, the Adviser must include the heading and an explanation that the information is inapplicable. If information provided in response to one item is also responsive to another item, the Adviser may cross-reference the information. Amended Form ADV, Part 2 also instructs each Adviser to include in its brochure descriptions of only those conflicts that the Adviser has or is reasonably likely to have, and practices in which it engages or in which it is reasonably likely to engage. If a conflict arises or the Adviser decides to engage in a practice that it has not disclosed, supplemental information must be provided to the client.

The Amendments also amend the following SEC rules under the Advisers Act:

- Rule 203-1 (which concerns applications for investment adviser registration) and Rule 204-1 (which concerns amendments to applications for investment adviser registration) to provide for the electronic filing of Form ADV, Part 2A and amendments with the IARD;
- Rule 204-2 (which concerns books and records to be maintained by investment advisers) to require the Adviser maintain, among other things, copies of the brochure supplements (Part 2B) in addition to copies of the brochure; and
- Rule 204-3 (which concerns the delivery of brochures and brochure supplements) to require delivery to clients of the brochure, brochure supplements and wrap fee program brochure, subject to certain exceptions.

The Amendments also rescind Rule 206(4)-4, which concerns financial and disciplinary information that must be disclosed to clients. The substance of that rule has been incorporated into Part 2A.

AMENDMENTS TO FORM ADV, PART 2

Part 2A: Brochure Items

Part 2A of amended Form ADV contains eighteen separate items, each covering a different disclosure topic. The instructions to Form ADV, Part 2A state that an Adviser may include a summary of the brochure at the beginning of the brochure followed by more detailed discussions of each item later in the brochure. The instructions also state that an Adviser may include in its brochure information that is not required by an item in Form ADV, provided that the Adviser does not include so much information that it obscures the required information.

The eighteen separate items include, among other things:

Material Changes. A brochure must identify and discuss in summary form the material changes that have occurred since the last annual update on the cover page or the following page, or as a separate document accompanying the brochure.

Advisory Business. Each Adviser must describe its advisory business, including the types of advisory services offered, whether it holds itself out as specializing in a particular advisory service and the amount of client assets that it manages. In describing the client assets it manages, an Adviser may calculate assets under management using different methodologies than what is required under Part 1A of Form ADV, so long as records are kept documenting the methodology used. Also, amended Form ADV states that Advisers are expected to update their assets under management annually and make interim amendments only for material changes in assets under management.

Fees and Compensation. An Adviser must describe how it is compensated for its advisory services, provide a fee schedule and disclose whether fees are negotiable. An Adviser must also disclose whether it bills clients or deducts fees directly from client accounts and how often it assesses fees, as well as describe other costs (*e.g.*, brokerage, custody fees, and fund expenses that clients may pay). In addition, an Adviser must disclose, if applicable, that it or its personnel may receive compensation attributable to the sale of an instrument (*e.g.*, brokerage commissions), describe the practice, the conflicts of interest it creates and how such conflicts are addressed.

Performance-Based Fees and Side-by-Side Management. An Adviser that charges performance-based fees or that has a supervised person who manages an account that pays such fees must disclose that fact. If the Adviser also manages accounts that are not charged a performance fee, the Adviser must also discuss the conflicts of interest that arise from its simultaneous management of these accounts and generally describe how it addresses those conflicts.

Types of Clients. The brochure must describe the types of clients the firm generally has, as well as the firm's requirements for opening or maintaining an account.

Methods of Analysis, Investment Strategies and Risk of Loss. An Adviser must describe its methods of analysis and investment strategies and disclose that investing in securities involves risk of loss. An Adviser must also provide specific disclosures of how strategies involving frequent trading can affect investment performance and explain the material risks involved for each "significant" (*i.e.*, that is relevant to most investors) investment strategy or method of analysis used and particular type of security it recommends, with more detail if those risks are unusual.

Disciplinary Information. An Adviser must disclose material facts about any legal or disciplinary event (but not an arbitration event) that is material to a client's (or a prospective client's) evaluation of the integrity of the Adviser or its management personnel. Disciplinary events that are required to be disclosed include events that are more than 10 years old, but do not include events concerning advisory affiliates. The Adviser also must provide a list of disciplinary events that are presumptively material, but the Adviser is permitted to rebut the presumptions if, among other things, it maintains records to enable the SEC staff to monitor compliance with such disclosure requirement.

Other Financial Industry Activities and Affiliations. An Adviser is required to describe material relationships or arrangements it (or any of its management persons) has with related financial industry participants, any material conflicts of interest that these relationships or arrangements create, and how the Adviser addresses such conflicts.

Codes of Ethics, Participation or Interest in Client Transactions and Personal Trading. Each Adviser must briefly describe its code of ethics and state that a copy is available upon request. In addition, if an Adviser or a related person recommends to clients, or buys or sells for client accounts, securities in which the Adviser has a material financial interest, the brochure must discuss this practice and the conflicts of interest presented by it. An Adviser must also disclose whether it or its related persons invests (or is permitted to invest) in the same securities that it recommends to clients, or in related securities (other than securities excepted from the definition of "reportable securities" under Rule 204A-1(e)(10) under the Advisers Act), and whether such investments may occur at or about the same time as a client's investments. If so, the brochure must discuss the conflicts presented and describe how the Adviser addresses the conflicts.

Brokerage Practices. An Adviser must disclose the existence of several practices associated with brokerage transactions that could involve conflicts of interest, including soft dollar practices, client referrals, directed brokerage and trade aggregations.

Soft Dollars. An Adviser must describe (a) how it selects brokers for client transactions and determines the reasonableness of brokers' commissions, (b) how it addresses conflicts of interest arising from the receipt of soft dollar benefits, (c) whether the benefits from soft dollars are

used for all client accounts or only those accounts whose brokerage “pays” for such benefits, (d) whether the Adviser seeks to allocate the benefits to client accounts proportionately to the soft dollar benefits those accounts generate, and (e) whether it pays more than the lowest available commission rate to obtain soft dollar benefits.

Client Referrals. If an Adviser uses client brokerage to compensate or reward brokers for client referrals, it must disclose this practice, the conflicts of interest it creates, and any procedures used to direct client brokerage to referring brokers during the last fiscal year.

Directed Brokerage. An Adviser that permits clients to direct brokerage must describe its practices in this area and explain that it may be unable to obtain the most favorable execution of client transactions, and that it may be more costly for clients. If the Adviser routinely recommends, requests or requires clients to direct brokerage, it must describe the practice, disclose that not all investment advisers require directed brokerage, and describe any relationship with a broker-dealer that creates a material conflict of interest.

Trade Aggregation. An Adviser must describe whether and under what conditions it aggregates trades. If the Adviser does not aggregate trades when it has the opportunity to do so, it must explain that clients may pay higher brokerage costs.

Review of Accounts. An Adviser must disclose whether and, if so, how often, it reviews clients’ accounts or financial plans and identify who conducts the review. An Adviser that does not review accounts regularly must explain what circumstances trigger an account review.

Client Referrals and Other Compensation. An Adviser must describe any arrangement under which it or a related person compensates another for client referrals, describe the compensation and disclose any arrangement under which the Adviser receives any economic benefit, including sales prizes, from a person who is not a client for providing advisory services to clients.

Custody. An Adviser with custody of client funds or securities must explain that clients will receive account statements directly from the qualified custodian that maintains those assets, explain that clients should carefully review those account statements, and, if the Adviser also sends client account statements, include a statement urging clients to compare the account statement from the qualified custodian and Adviser.

Investment Discretion. An Adviser with discretionary authority over client accounts must disclose that fact and any limitations clients may (or customarily do) place on the authority.

Voting Client Securities. An Adviser must disclose its proxy voting practices, including whether it accepts or will accept authority to vote client securities and, if so, describe its voting policies under Rule 206(4)-6 under the Advisers Act. An Adviser also must describe whether (and how) clients can direct it to vote in a

particular solicitation, how the Adviser addresses conflicts of interest when it votes securities, and how clients can obtain information from the Adviser on how the Adviser voted securities. An Adviser must also disclose that clients may obtain a copy of its proxy voting policies and procedures upon request. If an Adviser does not accept authority to vote securities, it must disclose how clients receive their proxies and other solicitations. An Adviser is not required to provide disclosure about its use of third-party proxy voting services or how it pays for such services.

Financial Information. An Adviser is required to disclose certain financial information when that information is material to clients. An Adviser that requires prepayment of fees must provide an audited balance sheet showing the Adviser's assets and liabilities at the end of its most recent fiscal year. In addition, an Adviser is required to disclose any financial condition reasonably likely to impair the Adviser's ability to meet contractual commitments to clients if the Adviser has discretionary authority over client assets, and it is required to disclose whether it has been the subject of a bankruptcy petition during the past ten years.

Appendix – Wrap Fee Programs. An Adviser that sponsors a wrap fee program will continue to be required to prepare a separate, specialized firm brochure for clients of the wrap program. Such brochure will be an appendix to the Adviser's Form ADV, Part 2A rather than Schedule H of Form ADV. In addition, the Adviser must identify whether any of its related persons is a portfolio manager in the wrap fee program and describe any associated conflicts.

Delivery and Updating the Brochure

The Amendments remove the general requirement that the brochure be delivered at least 48 hours prior to entering into an advisory contract as well as the alternative, that the brochure be delivered at the time the Adviser enters into an advisory contract provided that the client has five business days to terminate the contract. As amended, Rule 204-3 generally requires only that an Adviser deliver a current brochure before or at the time it enters into an advisory contract with the client.

Amended Rule 204-3 also requires an Adviser annually to provide to each client to whom they must deliver a brochure, either: (i) a copy of the current brochure that includes or is accompanied by the summary of material changes; or (ii) a summary of material changes that includes an offer to provide a copy of the current brochure. One or both of those documents must be provided no later than 120 days after the end of its fiscal year. Delivery may be done electronically pursuant to the SEC's electronic delivery guidelines. In addition, the Amendments require an Adviser to deliver an updated brochure promptly whenever the Adviser amends its brochure to add a disciplinary event or to change material information already disclosed regarding a disciplinary event.

An Adviser must also update its brochures filed electronically on the IARD at least annually and when any information becomes materially inaccurate (except the summary of material changes, which only has to be updated annually). If the brochure continues to be accurate since the last annual amendment, the Adviser would not have to prepare or file an updated firm brochure as part of its annual updating amendment. However, with any interim amendment, including those to correct a material inaccuracy, an Adviser would have to file a summary of material changes describing each interim amendment along with an updated firm brochure as part of its annual amendment filing. Although previously filed versions of

a brochure will remain in the IARD, only the most recent version of the brochure will be available to the public through the SEC's website.

PART 2B: THE BROCHURE SUPPLEMENT

As amended, Rule 204-3 also requires that an Adviser's brochure be accompanied by brochure supplements providing information about the advisory personnel from whom the particular client receives advice. An Adviser may include supplement information within the firm's brochure. Alternatively, an Adviser may prepare separate supplements for different groups of supervised persons. To promote comparability, a brochure supplement must be organized in the same order, and contain the same headings, as the items appear in the form, whether provided in a brochure or separately.

Supplement Items

The brochure supplement consists of the following six items:

Cover Page. The cover page must include, among other things, the name of the Adviser, the name of each supervised person covered by the supplement, as well as the addresses and telephone numbers. It also must include a statement stating that the document is a supplement to the brochure, that the recipient should have received a copy of the brochure and if not, of if the recipient has any question concerning the brochure or supplement who to call.

Educational Background and Business Experience. The supplement must describe each supervised person's formal education and his or her business background for the past five years, including whether the supervised person has no high school education, no formal education after high school or no business background. The business background section must also identify the supervised person's positions at prior employers. The Adviser may list any professional designations held by a supervised person. If such are listed, disclosure must provide a sufficient explanation of the minimum qualifications required for the designation.

Disciplinary Information. The supplement must disclose any legal or disciplinary event that is material to a client's evaluation of the supervised person's integrity, including certain disciplinary events that the SEC presumes are material. This includes the relinquishment of professional designations or licenses when the Adviser knew or should have known that the supervised person relinquished such designation or license. If an Adviser delivers a supplement electronically, it may satisfy this requirement by notifying clients of the supervised person's disciplinary history and including in the supplement hyperlinks to disciplinary information available through the FINRA BrokerCheck system ("BrokerCheck") or the SEC's Investment Adviser Public Disclosure system ("IAPD").

Other Business Activities. An Adviser must describe in the supplement other business activities of its supervised persons, specifically with respect to any investment-related business or any business that involves a substantial amount of time or pay, and any material conflicts of interest such activities may create. In addition, an Adviser must describe information about any compensation the supervised person receives based on the sales of securities or other investment

products to show any incentive for the supervised person to base investment recommendations on his or her own compensation rather than the clients' best interests.

Additional Compensation. The supplement must include a description of any arrangements in which someone other than a client gives the supervised person an economic benefit (such as a sales award) for providing advisory services.

Supervision. An Adviser must explain in the supplement how the firm monitors the advice provided by the supervised person addressed in the brochure supplement. It also must provide the name, title and telephone number of the person responsible for supervising the advisory activities of the supervised person.

Delivery and Updating

A client must generally be given a brochure supplement for each supervised person who: (i) formulates investment advice for that client and has direct client contact; or (ii) makes discretionary investment decisions for the client's assets. If investment advice is provided by a team consisting of more than five supervised persons, only the five supervised persons with the most significant responsibility for the day-to-day advice provided to the client need be disclosed. An Adviser does not need to deliver supplements to three types of clients: (i) clients to whom an Adviser is not required to deliver a firm brochure; (ii) clients who receive only impersonal investment advice, and (iii) certain "Qualified Clients" who are officers, directors, employees and other persons related to the Adviser. A supplement initially must be given to each client at or before the time when that specific supervised person begins to provide advisory services to that specific client.

Advisers must deliver an updated supplement to clients only when there is new disclosure of a disciplinary event, or a material change to disciplinary information already disclosed. When a reference to BrokerCheck or IAPD is made in an electronic supplement, a new supplement must be electronically delivered when either BrokerCheck or IAPD is updated with new disclosure of a disciplinary event or a material change to disciplinary information already disclosed. As with the brochure, the supplement must be amended promptly if the information in it becomes materially inaccurate. An Adviser is not required to deliver supplements to existing clients annually, as the information in the supplement is unlikely to become materially inaccurate over time.

FILING REQUIREMENTS

Form ADV, Part 2A must be filed electronically through IARD, which may be filed in text-searchable PDF format. An Adviser is not required to file brochure supplements or supplement amendments with the SEC, but must maintain copies of all supplements and amendments.

In the adopting release relating to the Amendments, the SEC stated that it believes that Advisers can provide information required by Part 2, without jeopardizing reliance on private offering exemptions for private funds in the Securities Act of 1933 and the safe harbor for offshore transactions in Section 5 of the statute, though it noted that providing private fund information beyond that required in Part 2 may jeopardize such reliance by constituting a private offering or conditioning the market for securities offered by such funds.

TRANSITION TO NEW REQUIREMENTS AND COMPLIANCE AND EFFECTIVE DATES

The amended rules and forms will be effective 60 days after publication of the rule in the Federal Register. A new Adviser applying for registration after January 1, 2011 must file a brochure or brochures that meet the requirements of amended Part 2A. An existing Adviser whose fiscal year ends on or after December 31, 2010 must include in its next annual updating amendment to its Form ADV a brochure or brochures that meet the requirements of the amended form. Thus, each existing Adviser must file an annual updating amendment with the new brochures no later than March 31, 2011. Within 60 days of filing such amendment, the Adviser must deliver to its existing clients a brochure and brochure supplement that meet the requirements of the Amendments. Each Adviser must after its initial filing begin to deliver the new brochure and brochure supplements to new and prospective clients.

Broad Agreement Reached on Basel III Capital and Liquidity Reform Package

The Basel Committee on Banking Supervision (the "BCBS") announced that the central bank governors and heads of banking supervision agencies from the BCBS's member countries reached "broad agreement on the overall design of the capital and liquidity reform package," including the definition of capital, the treatment of counterparty credit risk, the leverage ratio, and the global liquidity standard. The BCBS expects to finalize proposed capital buffers by the end of 2010, and the governors and heads of supervision agreed to finalize the capital set-aside requirements (*i.e.*, the percentage of risk-weighted assets required to be held) and phase-in arrangements at their next meeting in September, 2010. The BCBS also announced that it will publicly issue its economic impact assessment in August, 2010.

The BCBS noted that "one country still has concerns and has reserved its position until the decisions" on the final figures for the capital set-aside and the phase-in arrangements are decided in September, 2010. Germany's central bank, the Bundesbank, and its financial regulator, BaFin, later confirmed that Germany was the holdout, largely due to concerns regarding the definition of capital and how much capital a bank will be required to hold to meet Basel III criteria. In particular, Germany is reportedly seeking greater recognition of "silent participations" in savings banks, which are nonvoting shares, including government loans, that buffer bank capital positions.

A brief description of a number of the modifications agreed to by the governors and heads of supervision follows.

Definition of Capital

The BCBS retained most of the definition of capital proposals set out in its December 2009 consultative package, but noted that it had concluded that "certain deductions could have potentially adverse consequences for particular business models and provisioning practices, and may not appropriately take into account evidence of realizable valuations during periods of extreme stress." Accordingly, a number of changes were agreed upon, including the following:

- The BCBS will now allow “some prudent recognition of the minority interest supporting the risks of a subsidiary that is a bank,” while “excess capital above the minimum of a subsidiary that is a bank will be deducted in proportion to the minority interest share.”
- The BCBS agreed to eliminate a counterparty credit restriction (which provided that gross long positions of unconsolidated investments in financial institutions could be deducted net of short positions only if the short positions involved no counterparty risk) on hedging of financial institution investments and to include an underwriting exemption.
- Instead of requiring a full deduction of (1) significant investments (more than 10% of the issued share capital) in the common shares of unconsolidated financial institutions, (2) mortgage servicing rights, and (3) deferred tax assets, as proposed in December 2009, each such item may receive recognition up to 10% of a bank’s common equity component of Tier 1 capital. A bank must deduct the amount by which the aggregate of these three items exceeds 15% of its common equity component of Tier 1, with the items included in the 15% aggregate limit being subject to full disclosure.

Counterparty Credit Risk

The BCBS also announced a number of modifications to “the treatment of counterparty credit risk, including the bond equivalent approach to calculating the credit valuation adjustment (CVA).” These modifications include:

- Modifying the bond equivalent approach to address hedging, risk capture, effective maturity and double counting;
- Eliminating the 5x multiplier that was originally proposed to address the excessive calibration of the CVA;
- Keeping the asset value correlation adjustment at 25%, but raising the threshold from \$25 billion to \$100 billion; and
- Subjecting banks’ mark-to-market and collateral exposures to a central counterparty to a modest risk weight (in the 1-3% range).

Leverage Ratio

The BCBS agreed on a number of changes on the design and calibration for the leverage ratio, which will be calculated as an average over the quarter. For off-balance sheet items, the BCBS agreed to use uniform credit conversion factors (“CCFs”), with a 10% CCF for unconditionally cancellable off-balance sheet commitments, subject to further review to ensure that the 10% CCF is appropriately conservative based on historical experience. With respect to all derivatives (including credit derivatives), Basel II netting plus a simple measure of potential future exposure will be applied.

The BCBS is proposing to test a minimum Tier 1 leverage ratio of 3% during a parallel run period that will begin on January 1, 2013 and run through January 1, 2017. Banks will be required to begin disclosing their individual leverage ratio figures on January 1, 2015. Based on the results of this parallel run, any final adjustments would be carried out in the

first half of 2017, with full implementation beginning on January 1, 2018. The BCBS noted that while there is a “strong consensus to base the leverage ratio on the new definition of Tier 1 capital, the [BCBS] also will track the impact of using total capital and tangible common equity.”

Contingent Capital

At its July, 2010 meeting, the BCBS agreed to issue for consultation a “gone concern” proposal that requires capital to convert at the point of non-viability. The BCBS will also review a “fleshed-out proposal” for the treatment of “going concern” contingent capital at its December 2010 meeting with a progress report in September 2010.

Global Liquidity Standard

The governors and heads of supervision endorsed a number of revisions to the liquidity coverage ratio (“LCR”), which is designed to ensure that banks have sufficient high quality liquid resources to survive an acute stress scenario lasting for one month, with respect to the definition of liquid assets and how to measure the safety of different types of funding. These revisions include:

- *Retail and Small and Medium Sized Enterprise (“SME”) deposits*: lowering the run-off rate floors to 5% (stable) and 10% (less stable), respectively, from 7.5% and 15%;
- *Operational activities with financial institution counterparties*: introducing a 25% outflow bucket for custody and clearing and settlement activities, as well as selected cash management activities;
- *Deposits from domestic sovereigns, central banks, and public sector entities (“PSEs”)*: for unsecured funding, all sovereigns, central banks and PSEs will be treated as corporates (with a 75% roll-off rate), rather than as financial institutions with a 100% roll-off rate; for secured funding backed by assets that would not be included in the stock of liquid assets, a 25% roll-off of funding will be used;
- *Secured funding*: only recognizing roll-over of transactions backed by liquidity buffer eligible assets;
- *Undrawn commitments*: retail and SME credit lines will be lowered from 10% to 5%, and sovereigns, central banks, and PSEs will be treated similar to non-financial corporates with a 10% run-off for credit lines and a 100% run-off for liquidity lines;
- *Inflows*: rather than leaving it to bank discretion to determine the percentage of “planned” net inflows, a concrete harmonized treatment will be established; and
- *Definition of liquid assets*: all assets in the liquidity pool must be managed as part of that pool and are subject to operational requirements; the BCBS will also allow the inclusion of domestic sovereign debt for non-0% risk weighted sovereigns, issued in foreign currency, to the extent that this currency matches the currency needs of the bank’s operations in that jurisdiction; and will introduce a “Level 2” of liquid assets with a cap that allows up to 40% of the stock to be made up of these assets – including (with a 15% haircut) government and PSE assets qualifying for the 20% risk weighting

under Basel II's standardized approach for credit risk, and high quality non-financial corporate and covered bonds not issued by the bank itself.

The BCBS also noted that it remains committed to the introduction of the net stable funding ratio ("NSFR") as "a longer term structural complement to the LCR." However, the initial NSFR proposal is being significantly modified with a number of adjustments under consideration, including: (i) raising the Available Stable Funding factor for stable and less stable retail and SME deposits from 85% and 70% to 90% and 80%, respectively; (ii) lowering the Required Stable Funding factor to 65% for residential mortgages and other loans that would qualify for the 35% or better risk weight under Basel II's standardized approach; and (iii) lowering the extent to which off-balance sheet commitments would need to be pre-funded, by lowering the previous requirement of 10% stable funding to 5% required stable funding. The BCBS noted that it will carry out an "observation phase" before finalizing and introducing the revised NSFR as a minimum standard by January 1, 2018.

Upon being finalized by the BCBS, the Basel III provisions will still need to be implemented in the U.S. by the federal banking agencies, which could result in changes from the international agreement. In this regard, we note that Senator Christopher Dodd and Representative Barney Frank are each expected to hold hearings on the Basel III process amid reported concerns from some legislators that the proposed rules will be too weak.

The *Alert* will continue to monitor this area and provide updates on material developments as they occur.

DOL Issues Interim Final Regulation Regarding Service Provider Fee Disclosure

In recent years, significant attention has been focused on the compensation paid to entities that provide investment management, recordkeeping, and other services to 401(k) plans and other retirement plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). (Such ERISA-governed retirement plans, along with entities that are deemed to hold "plan assets" of such plans, are referred to in this article as "Plans".) A perception has developed that greater fee transparency may be needed to enable fiduciaries of Plans ("Plan Fiduciaries") to understand the relevant compensation arrangements better in connection with their selection and monitoring of service providers. Recently, the Department of Labor (the "DOL") issued an interim final regulation under Section 408(b)(2) of ERISA, as well as a corresponding ERISA prohibited transaction exemption, applicable to the provision of services to a Plan (including defined benefit pension plans and defined contribution retirement plans (*e.g.*, 401(k) plans), but not including certain types of "SIMPLE" plans and accounts or individual retirement accounts). Section 408(b)(2) of ERISA provides an exemption from ERISA's prohibited transaction rules for reasonable arrangements with service providers. The regulation will require certain Plan service providers to disclose to Plan Fiduciaries detailed information regarding fees and compensation.

The regulation will apply to the following types of service providers, which we refer to in this article as "Covered Service Providers," if it is reasonably expected that such service

provider (including its affiliates and subcontractors) will receive \$1,000 or more in direct or indirect compensation:

- Service providers who are fiduciaries under ERISA and who provide such ERISA fiduciary services either to the Plan itself or to a “plan assets vehicle” in which a Plan holds a direct equity interest, and investment advisers registered under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) or under applicable state law and who provide such services directly to the Plan;
- Providers of recordkeeping or securities brokerage services to self-directed individual account plans (*e.g.*, most 401(k) plans) if investment alternatives are made available in connection with such services (*e.g.*, through a platform); and
- Service providers who receive indirect compensation (*i.e.*, compensation received from any source other than directly from the plan, plan sponsor, the service provider or an affiliate or a subcontractor) for accounting, actuarial, appraisal, auditing, banking, custodial, insurance, investment advisory (plan or participant), legal, recordkeeping, securities brokerage, third-party administration, valuation services and/or certain types of consulting services.

Notably, the regulation does not apply to service providers who provide only non-fiduciary services to an investment fund (as contrasted to a retirement plan) that holds plan assets (*e.g.*, a bank collective fund).

The regulation would require Covered Service Providers to provide certain initial and ongoing disclosures in writing regarding their compensation arrangements. These requirements are in addition to the existing requirements under ERISA Section 408(b)(2), including requirements that a service provider’s compensation be reasonable and that the Plan’s arrangement with the service provider be terminable on reasonably short notice without penalty to the Plan. The disclosures that must be provided in writing reasonably in advance of whenever the service contract is entered into, extended or renewed include the following:

- A description of all services to be provided to the Plan pursuant to the contract or arrangement (the “Covered Services”);
- A statement, if applicable, that the Covered Service Provider or any affiliate or subcontractor reasonably expects to provide the Covered Services as a fiduciary under ERISA and/or the Advisers Act (or applicable state law);
- A description of all direct compensation that the Covered Service Provider, an affiliate or subcontractor reasonably expects to receive in connection with the Covered Services;
- A description of all indirect compensation (*i.e.*, all compensation received from any source other than the plan, plan sponsor, the Covered Service Provider or an affiliate or a subcontractor) that the Covered Service Provider, an affiliate or a subcontractor reasonably expects to receive in connection with the Covered Services, including identification of the services provided for, and the payer of, such indirect compensation;
- A description of any compensation for the Covered Services that will be paid among the Covered Service Provider, an affiliate, or a subcontractor if it is set on a transaction

basis (*e.g.*, commissions) or is charged directly against the Plan's investment and reflected in the investment's net value (*e.g.*, Section 12b-1 fees), including identification of the services provided for, and the payer and payee of, such compensation, even if such compensation is otherwise disclosed;

- A description of any compensation that the Covered Service Provider, an affiliate or subcontractor reasonably expects to receive in connection with the termination of the arrangement including how any prepaid amounts will be calculated and refunded;
- A description of how the compensation will be received (*e.g.*, billed to the Plan or deducted from the Plan's account); and
- In addition, there are additional specific disclosure requirements for certain types of Covered Service Providers, as follows:
 - Recordkeeping services: If it is reasonably expected that there will be no explicit compensation for recordkeeping services, or that compensation for such services will be offset or rebated based on other compensation, a reasonable good faith estimate must be provided of the implicit cost of such services to the Plan, including a detailed explanation of the services and a description of how the compensation will be received.
 - Fiduciary services: If a Covered Service Provider is a fiduciary to an investment contract, product or entity that holds plan assets and in which a Plan has a direct equity investment, a description of any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal from the contract, product or entity (*e.g.*, sales loads and redemption fees), the annual operating expenses (*e.g.*, expense ratio) of the contract product or entity, and any on-going expenses in addition to annual operating expenses (*e.g.*, wrap fees), unless such amounts are otherwise disclosed by the platform provider.
 - Investment disclosure for designated investment alternatives: If recordkeeping or brokerage services are provided to a self-directed individual account plan and certain designated investment alternatives are made available (*e.g.*, through a platform) in connection with such services, the fee disclosure detailed above regarding fiduciary services must be provided by the platform provider for each such designated investment alternative, which requirement can be met by providing current disclosure of the issuer if certain conditions are satisfied.

In addition, the Covered Service Provider must disclose any material changes in the required disclosures as soon as practicable, but not later than 60 days after acquiring knowledge of such material change. The regulation does not provide for any specific format for the required disclosures.

Under the regulation, "compensation" is broadly defined in the regulation to include money or any other thing of monetary value. Where the Covered Service Provider is not able to describe the compensation or fees in a specific monetary amount, it may provide a formula, percentage of Plan assets or per capita charge, provided such disclosure permits a reasonable Plan Fiduciary to evaluate the reasonableness of the compensation or fees.

While the regulation is similar in many respects to the guidance promulgated with respect to the new service provider fee disclosure requirements of Schedule C to the Form 5500, there are several notable differences. For example, compensation received by service providers to an investment fund is required to be disclosed on Schedule C, while the regulation exempts non-fiduciary service providers to such an investment fund from the disclosure requirements of the regulation. In addition, the threshold for disclosure on Schedule C is \$5,000 of compensation received by a service provider in a plan year, while it is \$1,000 of compensation under the contract or arrangement for purposes of the regulation.

The regulation becomes effective on July 16, 2011. For existing contracts and arrangements, Covered Service Providers must provide the required disclosures before the effective date. Comments on the interim final regulation are due by August 30, 2010.

In addition, the DOL finalized a class exemption applicable to Plan Fiduciaries for situations where, unbeknownst to the Plan Fiduciary, the service provider fails to provide the disclosure required by the regulation. In order for the relief under the class exemption to be available, the Plan Fiduciary must have reasonably believed that the disclosure requirements were satisfied, and must not have known or have had reason to know that the service provider failed to comply with the disclosure requirements. The exemption would require that the responsible Plan Fiduciary, upon discovering the disclosure failure, request in writing that the disclosures be made, and if such disclosure is not made within 90 days, notify the DOL of such failure within 30 days following the end of such 90-day period. The DOL also provided a model notice that Plan Fiduciaries may use for this purpose.

House Financial Services Committee Approves Covered Bonds Legislation

The House Financial Services Committee adopted by voice vote a bill (“H.R. 5823”) that would establish a legislative and regulatory framework for U.S. covered bonds, including a regime to handle the failure of a bond issuer. H.R. 5823 was introduced by Representative Scott Garrett, along with co-sponsors Representative Paul E. Kanjorski and Financial Services Committee Ranking Member Spencer Bachus, on July 22, 2010 to supersede a previous version (“H.R. 4884”) that was introduced in March 2010. While similar in many ways to H.R. 4884, H.R. 5823 also includes some significant differences, as discussed below. For more information on H.R. 4884, and covered bonds more generally, please see the [March 30, 2010 Alert](#). Covered bond provisions came very close to inclusion in the recently-enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), but ultimately did not make it out of the conference committee that reconciled the House and Senate versions of the Dodd-Frank Act.

H.R. 5823 originally designated the OCC as the “covered bond regulator” (unlike H.R. 4884, which designated the Secretary of the Treasury as the covered bond regulator). However, the FDIC, which said it supports expanding the covered bond market, has expressed concerns with certain details of the bill that it believes could potentially make bank failures more expensive. In partial response to this concern, the House Financial Services Committee adopted by voice vote an amendment from Representative Melissa Bean that would take regulation of covered bonds from the OCC and give it to a consortium of federal regulators, including the FDIC. Under this amendment, the OCC, FDIC, FRB and the SEC would have to promulgate joint rules dealing with covered bonds, with the primary regulator of the applicable financial institution enforcing such rules. The regulators

also would be required to consult with the FDIC for issuers who are depository institutions and confirm to the FDIC that covered-bond issuances by institutions under their jurisdiction would not “materially increase” the risk of losses or actual losses by the Deposit Insurance Fund.

Eligible issuers under H.R. 5823 include any insured depository institution or subsidiary thereof, any bank holding company or thrift holding company or any subsidiary thereof, and any nonbank financial company that is approved by its primary financial regulatory agency. Eligible asset classes for cover pools include residential and commercial mortgages, public sector loans and small business loans. A manager’s amendment offered by Representative Kanjorski eliminated eligible asset classes for home equity loans, auto loans, student loans and credit cards, but left in a provision that allows the covered bond regulators to jointly designate other eligible asset classes.

One important difference from H.R. 4884 is that, under H.R. 5823, the FDIC, if appointed as conservator or receiver for an issuer prior to a default under the issuer’s covered bonds, would have 180 days to elect to transfer the issuer’s covered bond program to another eligible issuer. Under H.R. 4884, the FDIC would have had only 15 days to make such a transfer. During such 180-day period, the FDIC would be required to satisfy all outstanding obligations of the issuer under the covered bonds and related transaction documents.

FDIC Chairman Sheila Bair expressed her continued concern with certain parts of the legislation in a letter to Representative Barney Frank, Chairman of the House Financial Services Committee. Specifically, Chairman Bair noted her concern that H.R. 5823 “would require the FDIC to hand over the excess collateral to covered bond investors without effective compensation.” Representative Bean offered an amendment to address the FDIC’s concerns, but reportedly withdrew the amendment when Chairman Frank promised to address such concerns before the bill reaches the floor of the House of Representatives.

In the Senate, Senator Bob Corker has urged Senate Banking Committee Chairman Christopher Dodd to hold a hearing on covered bonds as early as this week.

The *Alert* will continue to monitor this area and provide updates on material developments as they occur.

Federal Agencies Issue Final Rules on Mortgage Originator Identification

The OCC, FRB, FDIC, OTS, NCUA and the Farm Credit Administration (the “Agencies”) issued final rules (the “Rules”) under the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (the “SAFE Act”).

The SAFE Act requires that mortgage originators who work for financial institutions that are regulated by the Agencies register with the Nationwide Mortgage Licensing System (“NMLS”), a database of mortgage originators at banks, thrifts and credit unions. 48 states use NMLS to license and supervise mortgage brokers and originators, and it is expected that all 50 states will use NMLS by the end of 2010.

The Rules, which take effect on October 1, 2010 require that each mortgage originator at an institution regulated by any of the Agencies (i) obtain a unique identifier through NMLS

that will remain attached to that individual loan originator throughout his or her career, notwithstanding changes in employer and (ii) provide that identifier to customers. This is intended to allow consumers access to employment and background information on mortgage originators.

Mortgage lenders employed at institutions that are not supervised by the Agencies are required to be licensed in the states in which they operate and, if the state or states in which they are licensed offers the NMLS registry, the deadline for those mortgage lenders to be registered with NMLS was on July 31, 2010.

SEC Invites Public Comment on SEC Rulemaking and Studies pursuant to Dodd-Frank Act and Announces Procedures for Meetings Between Interested Parties and SEC Staff

The SEC [announced](#) that it has established a [page](#) on its website designed to facilitate public comment in advance of formal action by the SEC on the various topics that will be the subject of SEC rulemaking and studies under the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC also announced that the SEC staff will follow new procedures when meeting with interested parties regarding SEC rulemaking, as follows:

“Staff will try to meet with any interested parties seeking a meeting. When the number of requests exceeds availability, the staff will seek out parties with varying viewpoints. Staff may have to limit the number of meetings with similarly situated parties and will limit multiple meetings with the same party.

Staff will reach out as necessary to solicit views from affected stakeholders who do not appear to be fully represented by the developing public record on a particular issue.

Staff will ask those who request meetings to provide, prior to the meeting, an agenda of intended topics for discussion. After the meeting, the agenda will become part of the public record.

Meeting participants will be encouraged to submit written comments to the public file, so that all interested parties have the opportunity to review and consider the views expressed.”

Update on Accredited Investor – Net Worth Threshold Under Securities Act of 1933

As reported in our [July 23, 2008 Client Alert](#) and [our July 28, 2010 Alert](#), the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) provides that, effective July 21, 2010, the “net worth” threshold for a natural person to qualify as an “accredited investor” pursuant to regulations under the Securities Act of 1933 is \$1 million, excluding the value of the person’s primary residence. As the SEC has pointed out: “[T]he Act does not define the term ‘value,’ nor does it address the treatment of mortgage and other indebtedness secured by the residence for purposes of [this] net worth calculation.”

The SEC issued the following initial guidance on July 23, 2010: “When determining net worth for purposes of [1933 Act] Rules 215 and [Regulation D], the value of the person’s

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primary residence must be excluded. Pending implementation of the changes to the [SEC]’s rules required by the Act, the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor’s net worth.”

Documentation soliciting accredited investor representations (*e.g.*, private fund subscription agreements, transfer agreements and similar documentation) should be updated to reflect the Act’s revisions to the net worth threshold. In addition, individuals making (and those receiving) such representations may take into account this recent SEC guidance when determining such individuals’ liabilities for purposes of meeting that threshold.