

# FINANCIAL SERVICES ALERT

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## **DEVELOPMENTS OF NOTE**

### **SEC Staff Temporarily Suspends Requirement that Money Market Fund Boards Must Designate NRSROs**

The Staff (the “Staff”) of the SEC’s Division of Investment Management recently wrote to the Investment Company Institute (the “ICI”) announcing that it would not recommend enforcement action if a money market fund board did not designate at least four nationally recognized statistical rating organizations (“NRSROs”) whose ratings would be used by the fund to determine the eligibility of portfolio securities for the purposes of Rule 2a-7 under the Investment Company Act of 1940. The Staff also provided relief from related disclosure requirements for the designated NRSROs. The compliance timeline for the February 2010 amendments to Rule 2a-7 and other rules affecting money market funds would have required a money market fund to comply with both provisions by December 31, 2010.

In its letter to the ICI, the Staff said that its no-action relief would remain in effect until the SEC determines whether to modify Rule 2a-7 and remove all references in the rule to NRSROs, as required by Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (discussed in the [July 28, 2010 Alert](#)). Until such modifications to Rule 2a-7, the Staff said that a money market fund must continue to comply with its obligations for determining and monitoring whether its securities, other than unrated asset-backed securities, are or continue to be eligible securities for purposes of Rule 2a-7 as

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in effect before the February 2010 amendments to Rule 2a-7 took effect on May 5, 2010. The Staff said that a money market fund may continue to acquire unrated asset-backed securities as permitted by the February 2010 amendments. (Prior to the February 2010 amendments, a money market fund could acquire an asset-backed security only if the security was a rated security for purposes of Rule 2a-7.)

## **FINRA Proposes Amendments to Suitability and Know Your Customer Rules**

The SEC [published](#) a proposal by FINRA to adopt FINRA Rule 2111 (Suitability) and FINRA Rule 2090 (Know Your Customer) as part of the Consolidated FINRA Rulebook. The proposed rules are part of FINRA's continuing process of replacing the NASD and Incorporated NYSE Rules that continue to apply to member firms with FINRA Rules that are part of the Consolidated FINRA Rulebook. In this instance, as part of the consolidation, FINRA has proposed substantive changes to both rules. The text of the proposed rules is [available](#) on the FINRA website.

### **SUITABILITY RULE**

The essence of FINRA's suitability requirements is that a member firm may not make a recommendation to a customer unless the firm has a reasonable basis for concluding that what is being recommended is suitable for the customer. Current NASD Rule 2310 and its interpretive materials (i) distinguish between suitability obligations for retail accounts and those for institutional accounts, (ii) specify information to be obtained from retail and institutional accounts, and (iii) identify the elements of the suitability determination. Proposed FINRA Rule 2111 retains the general structure of NASD Rule 2310, but makes several key changes, including the following:

- The suitability obligation would apply to recommendations of investment strategies as well as recommendations of securities;
- The Rule would specifically list three components of the suitability determination: "reasonable basis" suitability, "customer specific" suitability and "quantitative" suitability; and
- The list of items to be considered in a retail customer's investment profile would be expanded.
- The Rule would clarify the means for satisfying the customer-specific suitability obligation for recommendations to an institutional account.

### **Investment Strategy Recommendations**

The text of FINRA Rule 2111 would refer specifically to a "recommended transaction or investment strategy involving a security or securities." FINRA believes that the suitability obligation already applies to recommendations of investment strategies, and notes that the term is currently used in NASD IM-2310-3, which addresses suitability obligations to institutional investors. The proposed rule would, however, exclude some categories of investment strategies, including general financial and investment information, such as basic investment concepts, information about an employer-sponsored retirement or benefit plan,

and asset allocation models that are, among other things, based on generally accepted investment theory. In the [regulatory notice](#) originally proposing FINRA Rules 2111 and 2090, FINRA requested comment on whether the suitability rule should also apply to recommendations of non-securities products. FINRA has determined, for now at least, to apply Rule 2111 only to recommended transactions and investment strategies involving securities.

### **Components of Suitability Determination**

In interpretive guidance, FINRA (and previously, the NASD) identified three components of suitability determinations. The reasonable basis obligation requires the person making a recommendation to have a reasonable basis to believe, based on adequate due diligence, that the recommendation is suitable for at least some investors. This obligation requires, among other things, that the person making the recommendation understand the product. The customer-specific obligation requires that the person making the recommendation have reasonable grounds to believe that the recommendation is suitable for a particular customer, based on the customer's investment profile. The quantitative suitability obligation requires that a member or associated person who has actual or de facto control over a customer account have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable when taken together. These components are proposed to be codified in Supplementary Material .03 of FINRA Rule 2111.

### **Retail Customer Investment Profile Considerations**

The principal distinction between retail and institutional accounts for purposes of the proposed rule is found in the means used to fulfill the customer-specific obligation. Pursuant to proposed FINRA Rule 2111(a), a customer-specific suitability determination for a retail customer must be based on information including, but not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and other information disclosed by the customer. This is an expansion of the list found in NASD Rule 2310, which specifically includes only financial status, tax status and investment objectives.

### **Customer-Specific Suitability for Institutional Accounts**

Proposed FINRA Rule 2111(b) would provide that a member or associated person would be deemed to have fulfilled the customer-specific suitability obligation for an institutional account (as defined in NASD Rule 3110(c)(4)) if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving securities and (2) the customer affirmatively indicates that it is exercising independent judgment in evaluating the recommendation. If the institutional account has delegated decision-making to an agent, such as an investment adviser, the analysis would be applied to the agent.

### **KNOW YOUR CUSTOMER RULE**

Currently, FINRA member broker-dealers have two know-your-customer obligations with different objectives. The first arises out of a broker's suitability obligations. A broker must

know its customer sufficiently well to make the required suitability determination. This obligation is implicit in NASD Rule 2310, the current suitability rule, covered to some extent in NASD Rule 3110(c) (account opening information) and explicitly stated in NYSE Rule 405(1). The second know-your-customer obligation for broker-dealers arises out of the anti-money laundering (“AML”) laws and regulations. The AML laws and regulations require brokers to be able to positively identify their customers, ascertain the sources of funds, and make observations about possible illicit uses of funds. The AML know-your-customer obligation is addressed indirectly by FINRA Rule 3310, which requires member firms to have an effective AML compliance program. Proposed FINRA Rule 2090 would require every member to “use due diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.” Proposed Supplementary Material .01 would specify that “essential facts” include not only those necessary to effectively service the customer’s account but those necessary to comply with applicable laws, regulations and rules.

In conjunction with adopting FINRA Rule 2090, FINRA proposes to eliminate many of the elements of NYSE Rule 405 as redundant or unnecessary. Of particular significance would be the elimination of the requirement of NYSE Rule 405(1) that a broker learn the essential facts relative to “every order.” FINRA believes this obligation is adequately addressed by specific order-handling rules of the SEC (*e.g.*, Regulation NMS) and FINRA (*e.g.*, NASD Rule 2320 on best execution) and by the reasonable-basis obligation of proposed FINRA Rule 2111.

#### **PUBLIC COMMENT AND SEC ACTION**

Comments on the proposed rule changes may be submitted on or before September 9, 2010. The SEC must act on the proposed rule changes by September 27, 2010 (subject to extension).

### **OFAC Adopts Iranian Financial Sanctions Regulations**

OFAC adopted the [Iranian Financial Sanctions Regulations](#) (the “IFSR”), 31 C.F.R. Part 561, which impose restrictions on the opening and maintaining of correspondent accounts and payable-through accounts by U.S. financial institutions for foreign financial institutions designated as having engaged in certain specified activities, such as facilitation of Iran’s pursuit of weapons of mass destruction or support for terrorist organizations. The IFSR also prohibit persons owned or controlled by U.S. financial institutions from engaging in transactions with Iran’s Islamic Revolutionary Guard Corps (“IRGC”) or its agents or affiliates, and makes U.S. financial institutions potentially responsible for such prohibited transactions by persons that they own or control. The ISFR implement Sections 104(c) and 104(d) of the Comprehensive Iran Sanctions, Accountability and Divestment Act (“CISADA”), which was signed into law by President Obama on July 1, 2010 to strengthen the U.S. sanctions regime against Iran.

The ISFR apply to a broad range of “U.S. financial institutions,” which are defined in the ISFR to include “any U.S. entity that is engaged in the business of accepting deposits, making, granting, transferring, holding, or brokering loans or credits, or purchasing or selling foreign exchange, securities, commodity futures or options, or procuring purchasers and sellers thereof, as principal or agent.” As specified in the ISFR, such institutions include but are not limited to “depository institutions, banks, savings banks, money services

businesses, trust companies, insurance companies, securities brokers and dealers, commodity futures and options brokers and dealers, forward contract and foreign exchange merchants, securities and commodity exchanges, clearing corporations, investment companies, employee benefit plans, and U.S. holding companies, U.S. affiliates, or U.S. subsidiaries of any of the foregoing.” The term “foreign financial institution” is defined with similar breadth.

**PROHIBITIONS OR STRICT CONDITIONS ON OPENING OR MAINTAINING CORRESPONDENT ACCOUNTS OR PAYABLE-THROUGH ACCOUNTS FOR DESIGNATED FOREIGN FINANCIAL INSTITUTIONS**

Pursuant to Section 104(c) of CISADA, the ISFR authorize the Treasury Secretary to prohibit or place strict conditions on the opening or maintaining of correspondent accounts or payable-through accounts in the United States by U.S financial institutions for any foreign financial institution that the Treasury Secretary determines knowingly:

- Facilitates the efforts of the Government of Iran (including efforts of the IRGC or any of its agents or affiliates) (i) to acquire or develop weapons of mass destruction or delivery systems for weapons of mass destruction or (ii) to provide support for organizations designated as foreign terrorist organizations;
- Facilitates the activities of a person subject to financial sanctions pursuant to United Nations Security Council Resolutions 1737, 1747, 1803, or 1929, or any other resolution adopted by the Security Council that imposes sanctions with respect to Iran (which includes individuals and entities designated by the Security Council as being engaged in, directly associated with or providing support for Iran’s proliferation sensitive nuclear activities, or the development of nuclear weapon deliver systems);
- Engages in money laundering or facilitates efforts by the Central Bank of Iran or any other Iranian financial institution to carry out any of the activities described above; or
- Facilitates a significant transaction or transactions or provides significant financial services for (i) the IRGC or any of its agents or affiliates designated as such by OFAC or (ii) a financial institution whose property and interests are blocked by OFAC in connection with Iran’s proliferation of weapons of mass destruction or delivery systems for weapons of mass destruction or Iran’s support for international terrorism.

The restrictions that the Treasury Secretary may impose on U.S. financial institutions with respect to the correspondent or payable-through accounts of such foreign institutions may include, but are not limited to:

- Prohibiting the provision of trade finance through the accounts;
- Restricting the types of transactions that may be processed through the accounts to certain types of transactions, such as personal remittances;
- Placing monetary limits on the transactions that may be processed through the accounts; or
- Requiring pre-approval from the U.S. financial institution for all transactions processed through the accounts.

Alternatively, the Treasury Secretary may impose a complete prohibition on the opening or maintaining of correspondent accounts or payable-through accounts by U.S. financial institutions for the designated foreign financial institution.

Any person who violates, attempts to violate, conspires to violate, or causes a violation of these prohibitions may be subject to civil penalties of up to the greater of \$250,000 or twice the amount of the transaction that forms the basis of the violation. In addition, willful violations may be punishable by criminal penalties of up to \$1,000,000, or, for individuals, imprisonment of up to 20 years, or both.

Under a general license provided in the ISFR, a U.S. financial institution may engage in certain limited transactions related to winding down and closing of a correspondent account or a payable-through account that the U.S. financial institution may no longer maintain for a designated foreign financial institution for ten days after the effective date of the prohibition with respect to that foreign financial institution. U.S. financial institutions that require more time or need to engage in a broader range of transactions with respect to such accounts must obtain a specific license from OFAC prior to engaging in any otherwise prohibited transactions.

#### **PROHIBITION ON TRANSACTIONS WITH THE IRGC OR ITS AGENTS OR AFFILIATES**

Pursuant to Section 104(d) of CISADA, the ISFR prohibit any U.S. person that is owned or controlled by a U.S. financial institution from knowingly engaging in any transaction with or benefiting the IRGC or any of its agents or affiliates designated as such by OFAC, as well as any entity owned 50% or more, directly or indirectly, by the IRGC.

A U.S. financial institution may be subject to civil penalties if any person that it owns or controls violates, attempts to violate, conspires to violate or causes a violation of this prohibition and the U.S. financial institution knew or should have known of the prohibited action by the person. The civil penalties assessed to the U.S. financial institution may amount to the greater of \$250,000 or twice the amount of the transaction that forms the basis of the violation.

#### **EFFECTIVE DATE AND FURTHER RELATED RULEMAKING**

The ISFR went into effect on August 16, 2010. The effective date of any prohibition or condition on the opening or maintaining of a correspondent account or payable-through account for a particular foreign financial institution is the earlier of the date the U.S. financial institution receives actual or constructive notice of the prohibition or condition. The prohibition on transactions with or benefiting the IRGC is effective August 16, 2010, except that the effective date with respect to transactions with or benefiting agents or affiliates of the IRGC is August 16, 2010 for agents or affiliates designated as such prior to that date and the date of actual or constructive notice of such designation for agents or affiliates designated after August 16, 2010.

Section 104(e) of CISADA directs the Secretary of the Treasury to adopt regulations that require U.S. financial institutions which maintain correspondent accounts or payable-through accounts in the United States for foreign financial institutions to conduct audits and report to Treasury regarding accounts maintained by the U.S. financial institutions for foreign institutions that may be engaged in transactions that would make them subject to designation under the ISFR. While Treasury was required to adopt the ISFR's provisions

within 90 days of the enactment of CISADA, there is no specific deadline for the adoption of these additional regulations.

## **FTC and DOJ Issue Revised Horizontal Merger Guidelines But Bank Merger Competitive Review Guidelines are Left Unchanged**

The Federal Trade Commission and the Department of Justice (the “Agencies”) issued major revisions to their Horizontal Merger Guidelines (the “[Guidelines](#)”), which replace the Horizontal Merger Guidelines originally issued in 1992 and modified in 1997. The Commentary on the Horizontal Merger Guidelines issued in 2006 remains a supplement to the newly revised Guidelines. The Bank Merger Competitive Review guidelines, which the federal banking agencies and the Department of Justice developed in 1995 to facilitate the competitive review of bank mergers, remain unchanged.

The Guidelines outline the principal analytical techniques, practices and the enforcement policy of the Agencies regarding horizontal mergers and acquisitions. Several examples of the evaluation of the different factors that are considered are provided. The Guidelines are intended to better reflect the Agencies’ actual practices and increase the transparency of the analytical process underlying enforcement decisions and to assist the courts in developing an appropriate framework for interpreting and applying antitrust laws. They are not intended to represent a change in the direction of merger review policy.

The Agencies have noted that, in contrast to the 1992 guidelines, the revised Guidelines:

- clarify that merger analysis does not use a single methodology, but is a fact-specific process through which the Agencies use a variety of tools to analyze the evidence to determine whether a merger may substantially lessen competition;
- introduce a new section on “Evidence of Adverse Competitive Effects,” which discusses several categories and sources of evidence that the Agencies, in their experience, have found informative in predicting the likely competitive effects of mergers;
- explain that market definition is not an end itself or a necessary starting point of merger analysis, and market concentration is a tool that is useful to the extent it illuminates the merger’s likely competitive effects;
- provide an updated explanation of the hypothetical monopolist test used to define relevant antitrust markets and how the Agencies implement that test in practice;
- update the concentration thresholds that determine whether a transaction warrants further scrutiny by the Agencies;
- provide an expanded discussion of how the Agencies evaluate unilateral competitive effects, including effects on innovation;
- provide an updated section on coordinated effects and clarify that coordinated effects, like unilateral effects, include conduct not otherwise condemned by the antitrust laws;

## **GOODWIN PROCTER FINANCIAL SERVICES PRACTICE**

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- provide a simplified discussion of how the Agencies evaluate whether entry into the relevant market is so easy that a merger is not likely to enhance market power; and
- add new sections on powerful buyers, mergers between competing buyers, and partial acquisitions.

### **OTHER ITEMS OF NOTE**

#### **SEC to Consider Proxy Rule Amendments Relating to Shareholder Nomination of Directors**

The SEC announced that the agenda for its open meeting scheduled for Wednesday, August 25, 2010, consists of considering whether to adopt changes to its rules designed to facilitate shareholder nomination of directors. In 2009, the SEC issued a [rule proposal](#) in this area, which was summarized in the [June 16, 2009 Alert](#).

#### **FRB-NY Expands its List of Counterparties Eligible to Participate in Reverse Repos by Adding 26 Money Market Funds**

The Federal Reserve Bank of New York (the “FRB-NY”) expanded the number of counterparties eligible to participate with the FRB-NY in reverse repurchase agreements. The new eligible participants are 26 money market funds (managed by a total of 14 investment managers, including, *e.g.*, Bank of America, BlackRock, Fidelity, Goldman Sachs, Legg Mason, Vanguard and Wells Fargo). The 26 new money market fund participants will join the existing 18 primary dealers currently eligible to participate in reverse repurchase transactions with the FRB-NY. The addition of the 26 new potential counterparties is a matter of “prudent advance planning,” said the FRB-NY, and is intended to enable the FRB-NY, when it deems it appropriate, to lower bank reserves and tighten monetary policy.