

FINANCIAL SERVICES ALERT

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In this Issue:

Developments of Note

- Enforcement of FTC Red Flags Identity Theft Rule Delayed until August 1, 2009
- FRB Releases Terms for Commercial Mortgage-Backed Securities Eligible to Serve as Collateral under the Term Asset-Backed Securities Loan Facility
- FDIC Issues Guidance on Risk Management of Investments in Structured Credit Products
- SEC Staff Announces Adviser/Fund CCO Regional Seminars
- OCC Issues Interpretive Letter Regarding Affiliate Lease of Aircraft
- Mutual Fund Directors Forum Issues Report on Director Oversight of Sub-Advisers

Other Items of Note

- FDIC Releases Guidance on Classification for High Loan to Value Refinancing Loans
- Sales under Section 363 of Federal Bankruptcy Code May Provide Significant Opportunities for Private Equity Firms

DEVELOPMENTS OF NOTE

Enforcement of FTC Red Flags Identity Theft Rule Delayed until August 1, 2009

The FTC announced that it is delaying until August 1, 2009 the effectiveness of its red flags rule requiring financial institutions to develop written identity theft prevention programs. (The November 1, 2008 compliance date for corresponding rules adopted by other federal agencies is unaffected by the FTC's action regarding its own red flags rule.) See <http://www.ftc.gov/opa/2009/04/redflagsrule.shtm> for the FTC announcement, which also indicates that the FTC will be issuing a identity theft program template designed for entities with a low risk of identity theft. The compliance template will be available on <http://www.ftc.gov/redflagsrule>, an FTC website with a variety of resources on identity theft prevention programs.

FRB Releases Terms for Commercial Mortgage-Backed Securities Eligible to Serve as Collateral under the Term Asset-Backed Securities Loan Facility

The FRB released the applicable terms for the use of cash (*i.e.*, non-synthetic) commercial mortgage-backed securities ("CMBS") as eligible collateral under the Term Asset-Backed Securities Loan Facility ("TALF"). The TALF is a FRB program administered by the Federal Reserve Bank of New York ("FRBNY") that is designed to restart the market for asset-backed securities ("ABS"). To date, the TALF has garnered limited participation. CMBS will be eligible as collateral for TALF loans starting in June 2009. The FRB had

previously stated that the TALF would be expanded to include CMBS, as discussed in the [March 24, 2009 Alert](#). The FRB further announced that securities backed by insurance premium finance loans will be eligible collateral under the TALF starting in June 2009.

The FRB also authorized TALF loans with maturities of three years and five years. Currently, all TALF loans have maturities of three years. TALF loans with five-year maturities will be available for the June TALF funding to finance purchases of CMBS, ABS backed by student loans, and ABS backed by loans guaranteed by the Small Business Administration. The FRB indicated that up to \$100 billion of TALF loans could have five-year maturities and that it will continue to evaluate that limit. Some of the interest on collateral financed with a five-year loan may be diverted toward an accelerated repayment of the TALF loan, especially in the fourth and fifth years.

Only CMBS with the highest long-term investment-grade rating category issued on or after January 1, 2009 will be eligible as collateral for the TALF. Eligible collateral will not include CMBS that obtains such credit ratings based on the benefit of a third-party guarantee or CMBS that a TALF CMBS-eligible rating agency has placed on review or watch for downgrade. Credit ratings will be set by credit rating agencies to be chosen by the FRBNY. The mortgage loans underlying eligible CMBS must have been originated on or after July 1, 2008 and be secured by a fee or leasehold interest in one or more income-generating commercial properties located within the United States. All mortgage loans must, among other things, be fixed-rate loans, and no mortgage loan may provide for interest-only payments during any part of its remaining term. The pooling and servicing agreement and other agreements governing the issuance of the eligible CMBS and the servicing of its assets must contain certain provisions related to control, distributions and appraisals.

As discussed above, each TALF loan secured by CMBS will have a three-year or five-year maturity, at the election of the borrower. Three-year TALF loans will bear interest at a fixed annual rate of 100 basis points over the 3-year Libor swap rate. Five-year TALF loans are expected to bear interest at a fixed annual rate of 100 basis points over the 5-year Libor swap rate. The collateral haircut for eligible CMBS with an average life of five years or less will be 15%. For eligible CMBS with an average life beyond five years, collateral haircuts will increase by one percentage point for each additional year of average life beyond five years. No eligible CMBS may have an average life beyond ten years. Any remittance of principal on the CMBS must be used immediately to reduce the principal amount of the TALF loan in proportion to the TALF advance rate. TALF borrowers must agree to refrain from exercising any voting, consent or waiver rights under the CMBS without the consent of the FRBNY. The FRBNY is considering a process to permit interested issuers, through a process to be determined, to reserve prospective funding of TALF loans collateralized by new issue CMBS. The FRBNY stated that if implemented, details of this process will be announced shortly.

FDIC Issues Guidance on Risk Management of Investments in Structured Credit Products

The FDIC issued a Financial Institution Letter, FIL-20-2009 (the "Letter") concerning risk management of investments in structured credit products. The FDIC said that the Letter is intended to reiterate and clarify existing supervisory guidance concerning a bank's purchase and holding of complex structured credit products, *e.g.*, mortgage-backed securities, collateralized debt obligations and asset-backed securities.

The Letter stresses that risk management of investments in structured credit products requires a thorough pre-purchase due diligence process, reasonable exposure limits, “accurate risk measurement, an understanding of the tranching structure, knowledge of the collateral performance, and a determination of investment suitability.” In evaluating a potential investment in a structured credit product a bank should consider not only credit ratings, but other factors, including whether the security in which the bank seeks to invest is subordinate to more senior tranches of the applicable securitization structure. Furthermore, the bank should consider the market risk, liquidity risk and operational risk associated with the proposed investment.

The Letter further states that a bank should be certain that the bank’s internal risk management and reporting systems are “tailored to the risk profile of the investment portfolio.” Moreover, the Letter states that a bank should have a “reasonable, documented and consistently applied approach to pricing high-risk, illiquid, complex structured credit products.”

The FDIC also states that bank examiners’ classifications of structured credit products will continue to be governed by the 2004 Interagency Uniform Agreement on the Classification of Assets and Appraisal of Securities. The Letter notes that under the Uniform Agreement bank examiners may adversely classify an investment in a structured credit product even though the investment bears an investment grade credit rating. Finally the Letter discusses capital treatment of investments in structured credit products.

SEC Staff Announces Adviser/Fund CCO Regional Seminars

The SEC staff announced its 2009 CCO Outreach Regional Seminars for adviser and fund chief compliance officers, which will take place in May, June, and July. Ten seminars will be available via live audio and video webcast. The topics covered at the Regional Seminars will include significant focus areas during examinations, including how the staff identifies deficient practices and control weaknesses and controls advisers have instituted to mitigate and manage risks. The SEC’s announcement suggests that the topics may be most beneficial for mid-size and smaller adviser CCOs. The Regional Seminars often include question-and-answer sessions and, given their smaller size, are more conducive to audience interaction than the National Seminar. In addition, CCOs that attend a Regional Seminar may interact with the staff from their local SEC office. (CCOs in the region where a Regional Seminar is held are given preference in the selection of the limited number of people allowed to attend in person.) Registration for attendance in person or via webcast is available at <http://secregistration.connectlive.com/>. The agenda for the Regional Seminars is posted on the SEC website at <http://www.sec.gov/info/cco/ccorsagenda2009.htm>.

OCC Issues Interpretive Letter Regarding Affiliate Lease of Aircraft

The OCC issued an Interpretive Letter (“Letter #1114”), regarding the applicability of Section 23A (“Section 23A”) of the Federal Reserve Act (the “Act”), and the FRB’s Regulation W, (“Regulation W”) to the lease of an aircraft by an operating subsidiary of a national bank (the “Bank”) to the Bank’s holding company (the “BHC”). The BHC, a major foreign financial services holding company, owned the aircraft; however, for tax and other reasons, the Bank stated that it would be advantageous if the Bank owned the aircraft and leased it to the BHC. The aircraft had a fair market value of \$20 million. Under the proposed lease transaction, the Bank would form the operating subsidiary, which would then purchase the aircraft from the BHC for \$19 million. The lease would be structured to

satisfy the requirements of 12 U.S.C. § 24(Tenth), which prohibits a national bank from investing in tangible personal property for lease financing transactions on a net lease basis if such investment exceeds 10 percent of the assets of the national bank. The term of the lease would be five years with a possibility of renewal. The monthly lease payments would be \$200,000. The Bank asked what the value of the transaction would be and whether the leased aircraft could be treated as collateral for purposes of Section 23A.

Value of Transaction. The OCC concluded in Letter #1114 that the lease would be treated as a loan or extension of credit to an affiliate that is subject to Section 23A and Section 23B of the Act. Therefore, the OCC determined, the lease was a “covered transaction” under Section 23A subject to capital-based quantitative limits. Regulation W provides three options for the valuation of a credit transaction: (i) the principal amount of the transaction; (ii) the amount owed by the affiliate to the member bank under the transaction; or (iii) the sum of – (A) the amount provided to, or on behalf of, the affiliate in the transaction; and (B) any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction. The OCC concluded that the value of the transaction at issue was the “amount provided to...the affiliate in the transaction,” which in this case was the book value of the aircraft, or \$20 million. The OCC further noted that the \$1 million difference between the fair market value of the aircraft and the purchase price should be accounted for as a contribution to capital.

Collateral. Section 23A requires a member bank to obtain collateral equaling 100 to 130 percent of a loan or extension of credit to an affiliate, depending on the type of collateral received. The OCC concluded that the leased aircraft should be considered collateral for purposes of Section 23A, noting that in the case of a lease, “the lessor actually has a better form of security than [Regulation W] requires – ownership of the property, as opposed to a mere security interest” and that “[t]reating the leased property as collateral for purposes of section 23A makes economic and practical sense while still upholding the safety and soundness concerns behind section 23A’s collateral requirement.” The amount of collateral that Section 23A requires for personal property, such as the aircraft, is 130 percent. Because in round numbers, \$20 million is 130 percent of \$15,385,000, Letter #1114 states that the BHC would need to provide the Bank with \$4,615,000 in additional collateral.

Mutual Fund Directors Forum Issues Report on Director Oversight of Sub-Advisers

The Mutual Fund Directors Forum (“MFDF”) issued a report providing practical guidance to mutual fund directors whose funds engage sub-advisers. In broad terms, the report examines the different ways sub-advisers are used and provides advice on overseeing all phases of a fund’s relationship with a sub-adviser. The report initially focuses on how a fund board works with a fund’s adviser, including how a board should familiarize itself with the adviser’s sub-adviser search/selection process, evaluate the adviser’s ability to monitor a sub-adviser on an ongoing basis and analyze the adviser’s fee in light of the allocation of duties between it and the sub-adviser. The report devotes considerable attention to board evaluation of sub-advisers including: dealing with situations where certain kinds of information about a sub-adviser are not available; understanding a sub-adviser’s investment expertise; evaluating a sub-adviser’s organizational and compliance structure; comparing proposed sub-advisers to the sub-advisers they will replace; evaluating the appropriateness of a sub-advisory fee, including differing considerations for affiliated and unaffiliated sub-advisers; and special considerations for the multi-sub-adviser and affiliated sub-adviser arrangements. The report emphasizes that independent directors must exercise appropriate care, both when engaging a sub-adviser and on an ongoing basis, to ensure that their

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investment activities and those of their immediate family members do not undermine their independent status. In terms of overseeing sub-adviser relationships on an ongoing basis, the report discusses ways to use a fund's chief compliance officer and examines different issues relating to ongoing communication between a fund board and a sub-adviser, including the frequency and type of meetings. The report singles out the following areas of sub-adviser activity for board oversight: soft dollar procedures, trade allocation, complex instruments, proxy voting and valuation. The report concludes with a discussion of issues relating to sub-adviser termination and the transition from a terminated sub-adviser to a successor sub-adviser.

OTHER ITEMS OF NOTE

FDIC Releases Guidance on Classification for High Loan to Value Refinancing Loans

The FDIC issued a Financial Institution Letter (FIL-19-2009 the "FIL") that states that loans to refinance performing mortgages to grant a lower interest rate should not adversely affect the classification of those loans, even if the loan-to-value ("LTV") ratio increases, so long as the loan complies with sound underwriting guidelines. The FDIC refers back to the classification standards for high LTV residential refinancing loans in the previously issued Uniform Classification and Account Management Policy, which note that classification should be based primarily on the borrower's repayment history rather than the value of the collateral. The FIL states that declining property values and owner equity have prevented many performing residential borrowers from refinancing at lower current interest rates. The FIL is available at <http://www.fdic.gov/news/news/financial/2009/fi109019.html>.

Sales under Section 363 of Federal Bankruptcy Code May Provide Significant Opportunities for Private Equity Firms

Goodwin Procter's Private Equity and Financial Restructuring Practices issued a Client Alert concerning opportunities for private equity firms in the current leverage constrained market. The debt crisis has largely eliminated the availability of debt financing for LBO transactions and owners of healthy businesses are holding their properties off the market rather than attempting to gain liquidity against the headwinds of wounded private equity buyers and cautious lenders. Under the current conditions, bankruptcy auctions pursuant to Section 363 of the Federal Bankruptcy Code may yield significant values, and opportunistic private equity firms may wish to consider taking advantage of this market. Goodwin Procter's [April 28, 2009 Client Alert](#) highlights some of the opportunities, strategies and technical aspects to consider when approaching Section 363 sales.