

FINANCIAL SERVICES ALERT

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DEVELOPMENTS OF NOTE

Obama Administration Submits Draft Legislation on Hedge Fund Adviser Registration to Congress

The Obama administration has provided Congress with draft legislation entitled the [Private Fund Investment Advisers Registration Act of 2009](#) (the "Proposed Legislation"). The Proposed Legislation is designed to implement the recommendations regarding hedge fund oversight made in the U.S. Treasury Department's ("Treasury") white paper, "*Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation*," which outlined the Obama administration's plans to reform the U.S. financial regulatory system. (For a more detailed summary of the Treasury white paper, please see the [June 23, 2009 Alert](#)).

The Proposed Legislation has two principal elements. First, it would effectively eliminate the registration exemption under the Investment Advisers Act of 1940 (the "Advisers Act") currently available to advisers that do not hold themselves out to the public as investment advisers and who have fewer than 15 clients (the "private adviser exemption") by making the exemption available only to non-U.S. based advisers with fewer than 15 U.S. clients and very limited U.S. sourced assets under management. This element of the Proposed Legislation would cause advisers that have heretofore relied on the private adviser exemption, including advisers to many types of private investment pools, such as hedge

funds, private equity funds and venture capital funds, to register with the SEC. The second principal element of the Proposed Legislation involves giving the SEC recordkeeping, reporting and inspection authority so that it can gather and share information about “private funds” managed by *all* registered advisers. Under the Proposed Legislation, a private fund is any fund that (a) relies on the exceptions from the definition of “investment company” under the Investment Company Act of 1940 (the “1940 Act”) contained in Sections 3(c)(1) or 3(c)(7) of the 1940 Act and (b) is either organized under U.S. law or has 10 percent or more of its outstanding securities owned by U.S. persons.

I. SEC Oversight of Private Funds

The Proposed Legislation would give the SEC authority to (a) require recordkeeping and reporting by all registered investment advisers regarding their private funds, (b) inspect private fund records maintained by all registered investment advisers, (c) require registered advisers to private funds to make disclosures to private fund investors, prospective investors, counterparties and creditors, and (d) require the SEC to share information about private funds with other federal regulatory bodies for risk assessment purposes. Regulatory reporting would be on a confidential basis and would, at a minimum, encompass (1) assets under management, (2) leverage (including off-balance sheet leverage), (3) credit risk exposures, (4) trading and investment positions, (5) trading practices and (6) other information that the SEC and the Board of Governors of the Federal Reserve System (the “Federal Reserve”) consider necessary or appropriate. The Proposed Legislation would require the SEC to provide systemic risk data and reports on private funds to the Federal Reserve and to the Financial Services Oversight Council proposed in the Treasury white paper. The Proposed Legislation includes a provision expressly allowing the SEC to adopt rules assigning different meanings to definitions, including the definition of “client,” used in different sections of the Advisers Act. This provision is designed to address any limits on SEC rulemaking under the Advisers Act that might exist because of a decision in which the U.S. Court of Appeals for the D.C. Circuit vacated 2004 SEC rulemaking seeking to require registration of hedge fund advisers (see the [June 27, 2006 Alert](#) for a discussion of that decision).

II. Other Legislative Proposals Addressing Hedge Fund Oversight

The Proposed Legislation joins three other legislative proposals currently pending in Congress that address the issue of “hedge fund” oversight. [S. 344](#) is the only proposal that focuses on private fund, as opposed to adviser, registration. It would effectively require any private fund with more than \$50 million to register with the SEC as an investment company. [HR. 711](#) is similar to the Proposed Legislation in that it seeks greater transparency regarding private investment pools by eliminating the private adviser exemption. H.R. 711 does not, however, seek to supplement SEC rulemaking authority. [S.1276](#), which was introduced days before the Treasury white paper was issued, is the most similar to the Proposed Legislation. S.1276 would narrow the private adviser exemption to apply only to non-U.S. advisers with fewer than 15 clients representing less than \$25 million in assets. The bill would also broaden SEC authority regarding registered adviser reporting and recordkeeping, particularly with respect to private funds, but not to the extent contemplated under the Proposed Legislation.

III. Congressional Testimony and Industry Reactions

At a [July 17, 2009 hearing](#) before the House Committee on Financial Services, industry participants provided detailed reactions to the Obama administration's proposal to regulate private fund advisers. Of particular note, Richard Baker of the Managed Funds Association voiced support for the registration of unregistered advisers, stating that "smart regulation" supports proper market functioning and indicating a strong desire to interact with regulators as specific regulatory reforms are implemented. Mr. Baker's testimony also advocated that the registration requirements apply to advisers to "all private pools of capital." In addition to the reactions from the Managed Funds Association, the regulatory goals articulated in the Proposed Legislation have received industry support from the Private Equity Council and the Securities Industry and Financial Markets Association.

At a [July 15, 2009 hearing](#) before the Subcommittee on Securities, Insurance and Investment of the U.S. Senate Committee on Banking, Housing and Urban Affairs, Andrew Donohue, Director of the SEC's Division of Investment Management, discussed the SEC's support for requiring private advisers to register under the Advisers Act. In addition to discussing the potential regulation of trading activities of private advisers, Mr. Donohue also discussed the possibility that the SEC may seek to directly regulate private funds, although the Proposed Legislation, as drafted, focuses on adviser registration, not registration of private funds. In other testimony at the July 15, 2009 hearing, the National Venture Capital Association reiterated its opposition to the application of any private fund adviser registration and reporting initiative to the venture capital industry

Basel Committee Announces Basel II Capital Framework Enhancements

The Basel Committee on Banking Supervision (the "BCBS") announced that it has approved a number of measures to enhance the Basel II capital framework ("Basel II") and to strengthen the rules governing trading book capital. These measures are part of the BCBS's broader program to strengthen the regulatory capital framework in response to the financial crisis that began in 2007 by introducing new standards to: (1) promote the build-up of capital buffers that can be drawn down in periods of stress; (2) strengthen the quality of bank capital; and (3) introduce a leverage ratio as a backstop to Basel II. The BCBS is also taking measures to mitigate any excess cyclicality of the minimum capital requirements and to promote a more forward-looking approach. The BCBS intends to issue a consultative paper on this broader program by the first quarter of 2010.

Under the approved Basel II enhancements, the BCBS is strengthening the treatment for certain securitizations in Pillar 1 (regarding minimum capital requirements) of Basel II. The BCBS is introducing higher risk weights for resecuritization exposures (so-called collateralized debt obligations of asset-backed securities) to better reflect the risk of such products, and is raising the credit conversion factor for short term liquidity facilities to off-balance sheet conduits. In addition, the BCBS is requiring that banks conduct more rigorous credit analyses of externally rated securitization exposures in order to ensure that banks perform their own due diligence and do not simply rely on rating agency credit ratings.

Furthermore, the BCBS is issuing supplemental guidance under Pillar 2 (the supervisory review process) of Basel II. This supplemental guidance "addresses the flaws in risk management practices revealed" by the financial crisis. More specifically, these proposed measures address: firm-wide governance and risk management; capturing the risk of off-

balance sheet exposures and securitization activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; and sound compensation practices. The supplemental guidance also incorporates the *FSF Principles for Sound Compensation Practices* issued by the Financial Stability Board (formerly known as the Financial Stability Forum) in April 2009.

The BCBS has also proposed measures to enhance Basel II's Pillar 3 (regarding market discipline) by strengthening disclosure requirements in several important areas, including: securitization exposures in the trading book; sponsorship of off-balance sheet vehicles; resecuritization exposures; and pipeline and warehousing risks with regard to securitization exposures. The BCBS noted that these "additional disclosure requirements will help reduce market uncertainties about the strength of banks' balance sheets related to capital market activities."

The BCBS expects banks and supervisors to begin immediately to implement the Pillar 2 guidance, while the new Pillar 1 capital requirements and Pillar 3 disclosures are expected to be implemented no later than December 31, 2010. In the meantime, the BCBS agreed to keep in place the Basel I capital floors, which required banks to set aside capital equivalent to 8% of an institution's risk-weighted assets, beyond the end of 2009.

With respect to the revisions to the trading book rules, which will take effect at the end of 2010, the BCBS announced the introduction of higher capital requirements, including the implementation of an incremental risk capital charge (which includes default risk as well as migration risk) for unsecuritized credit products, to capture the credit risk of complex trading activities and reduce the incentive for regulatory arbitrage between the banking and trading books. The proposed measures also include a stressed value-at-risk (VaR) requirement, which the BCBS "believes will help dampen the cyclicity of the minimum regulatory capital framework."

The proposed enhancements to Basel II have not yet been implemented by the federal banking agencies in the US. Once implemented, they will apply only to "core banks" required to adopt Basel II in the US and those banking institutions that opt-in to applying Basel II in the US. A US depository institution is a core bank if it (1) has consolidated total assets of \$250 billion or more on year-end regulatory reports, (2) has consolidated total on-balance sheet foreign exposure of \$10 billion or more at the most recent year-end, or (3) is a subsidiary of another depository institution or bank holding company that is a core or opt-in bank. Similarly, a US-chartered bank holding company is a core bank if the bank holding company either (i) meets the consolidated asset thresholds described above for banks (excluding from the \$250 billion asset calculation assets of insurance underwriting subsidiaries), or (ii) has a subsidiary bank that is a core or opt-in bank.

FinCEN Issues ANPR Seeking Comment on Application of AML Compliance Requirements to Residential Mortgage Lenders and Originators

The Financial Crimes Enforcement Network ("FinCEN") issued an advance notice of proposed rulemaking (the "ANPR") seeking public comment on whether and how to apply anti-money laundering ("AML") compliance requirements and suspicious activity report ("SAR") regulations to non-bank residential mortgage lenders and originators. In 2003, FinCEN issued an earlier ANPR involving Bank Secrecy Act ("BSA")/AML compliance requirements for non-bank mortgage lenders, but the 2003 ANPR did not result in the adoption of any final regulations.

In the ANPR, FinCEN stated that residential mortgage lenders and originators are “in a unique position to assess money laundering risks and possible mortgage fraud while directly assisting consumers with their financial needs and protecting them from the abuses of financial crime.” In addition, FinCEN expressed a concern that, currently, a “regulatory gap” exists between BSA/AML coverage of bank residential mortgage lenders and non-bank residential mortgage lenders, and that the existence of that gap makes non-bank residential mortgage lenders particularly vulnerable to mortgage fraud and other financial crimes.

In the ANPR, FinCEN seeks public comment on:

- (1) whether FinCEN should take an “incremental approach” to BSA/AML compliance regulations for loan and finance companies by having such regulations initially only apply to residential mortgage lenders and originators;
- (2) how BSA/AML compliance regulations should define residential mortgage lending or origination. The ANPR notes that mortgage companies will be required to comply with the nationwide licensing system and registry being developed pursuant to the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (the “S.A.F.E. Act”). FinCEN seeks comment on whether FinCEN should adopt, for BSA/AML compliance purposes, the definitions used by the S.A.F.E. Act for “loan originator” and for “residential mortgage loan”;
- (3) the financial crime and money laundering risks posed by residential mortgage lenders and originators;
- (4) how BSA/AML programs for residential mortgage lenders and originators should be structured;
- (5) whether residential mortgage lenders and originators should be covered by BSA/AML compliance requirements other than the requirement to establish a BSA/AML compliance program, including SAR reporting (*e.g.*, should they be required to file currency transaction reports?); and
- (6) whether any subset of residential mortgage lenders or originators should be exempted from BSA/AML compliance requirements or SAR reporting requirements.

Comments on the [ANPR](#) are due to FinCEN by August 20, 2009.

Federal District Court Rejects Citigroup’s Claim that Exclusivity Agreement Bars Wells Fargo-Wachovia Acquisition

In *Wachovia Corp. v. Citigroup Inc.*, the U.S. District Court for the Southern District of New York (the “Court”) rejected the claim of Citigroup Inc. (“Citigroup”) that an exclusivity agreement in connection with its planned acquisition of Wachovia Corp. (“Wachovia”) barred Wachovia from reaching a separate agreement to be acquired by Wells Fargo Corp. (“Wells Fargo”). This is the first decision to interpret and apply Section 126(c) (“Section 126(c)”) of the Emergency Economic Stabilization Act (“EESA”).

The claim arose from Citigroup's attempted acquisition of Wachovia in September 2008. Citigroup and Wachovia entered into an agreement in principle that involved FDIC assistance. Barring a purchase of Wachovia by another institution, the FDIC was planning to put Wachovia into receivership by October 6, 2008. Although the terms of an exclusivity agreement (the "Exclusivity Agreement") with Citigroup barred Wachovia from seeking competing offers, Wells Fargo made a successful offer for Wachovia on October 2, 2008 and a definitive agreement was signed on October 3, the same day EESA was signed into law. Citigroup sued Wachovia and Wells Fargo, claiming that the exclusivity clause made the Wells Fargo-Wachovia transaction unenforceable under Section 126(c), which prohibits agreements that restrict acquisitions in connection with emergency actions by the FDIC. Wachovia responded to Citigroup's claim seeking declaratory judgment that the merger between Wachovia and Wells Fargo was valid, proper and not prohibited by the exclusivity agreement with Citigroup due to the effect of Section 126(c).

The Court agreed with Wachovia, stating that Section 126(c) makes the exclusivity clause in the Citigroup-Wachovia agreement unenforceable. The Court found that the Wells Fargo-Wachovia transaction "was part of an FDIC-supervised rescue and therefore was permitted to benefit from Section 126(c). The Court further found that "there is no doubt that Wells Fargo's offer to acquire [Wachovia] ... was 'in connection with' a sale of Wachovia, and therefore Section 126(c) applies to render the Exclusivity Agreement unenforceable."

This decision is likely to strengthen the FDIC's ability to encourage acquisitions of troubled institutions, however, it is also likely to create uncertainty in such transactions because they could be subject to intervention by federal regulators.

FinCEN Announces that it will Provide Acknowledgements for Electronic Filings of SARs

The Financial Crimes Enforcement Network ("FinCEN") announced that it will implement a system in September 2009 that will provide acknowledgements for suspicious activity reports ("SARs") filed electronically by depository institutions, broker-dealers, investment companies, casinos, money service businesses and others. The new functionality will give a document control number to those who file an SAR electronically as an acknowledgement of receipt for the originally submitted SAR.

FinCEN stated that its Bank Secrecy Act ("BSA") E-filing system will allow filers to self-enroll to receive SAR acknowledgements. Furthermore, FinCEN said that in August 2009, it will make available an SAR acknowledgement questions and answers document. SAR acknowledgements will not be provided to those who file SARs in paper form rather than electronically. FinCEN also stated that in December 2009, it will implement SAR validations, which will "provide filers with feedback on the quality of their submission."

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OTHER ITEMS OF NOTE

Goodwin Procter Issues Client Alert on Enactment of Uniform Prudent Management of Institutional Funds Act in Massachusetts

Goodwin Procter has issued a [Client Alert](#) that discusses the enactment in Massachusetts of the Uniform Prudent Management of Institutional Funds Act, which (a) modernizes the rules governing expenditures from endowment funds, (b) adopts more explicit standards for the prudent management and investment of charitable funds, (c) permits delegation of the management and investment of charitable funds to external agents and (d) makes it easier to obtain release or modification of restrictions on charitable gifts.

SEC to Consider Proposing Pay to Play Rules for Advisers Relating to Advisory Contracts with Public Entities

The SEC announced that at its open meeting on Wednesday, July 22, 2009 at 2:00 p.m. it will consider whether to “propose a rule to address ‘pay to play’ practices by investment advisers.” The SEC’s announcement describes the proposal as “designed, among other things, to prohibit advisers from seeking to influence the award of advisory contracts by public entities through political contributions to or for those officials who are in a position to influence the awards.”