

Developments of Note

◆ **SEC Issues Release Proposing Confirmation and Point of Sale Disclosure Requirements for Mutual Fund, UIT and 529 Plan Sales**

The SEC issued a release discussing new rules and form amendments approved at its January 14, 2004 meeting (discussed in the January 20, 2004 *Alert*) (the "Proposal") that would introduce point of sale and additional confirmation disclosure requirements applicable to brokers, dealers and municipal securities dealers (collectively, "broker-dealers") in sales of (a) certain mutual funds and unit investment trusts ("UITs") and (b) municipal fund securities used for college savings ("529 Plans"), (collectively, "Covered Securities"). The Proposal would also require additional Form N-1A disclosure about sales loads and revenue sharing. (The requirements discussed in the Proposal would not apply to transactions in mutual funds or UITs traded on exchanges, which would continue to be subject to Rule 10b-10 confirmation requirements. The SEC requested comment on whether the Proposal should apply to interval funds.) Under the Proposal, confirmations would generally track existing Rule 10b-10 requirements regarding the basic characteristics of a transaction such as date and price information but would also include additional sales load, service fee and dealer concession disclosure along with (a) quantitative information about (i) revenue sharing with the selling broker-dealer and its affiliates by the issuer's fund complex, including the investment advisers to Covered Securities issuers in the fund complex and the advisers' affiliated persons, and (ii) commissions, including mark ups or other remuneration associated with riskless principal transactions, received by the selling broker-dealer and its affiliates for transactions on behalf of any Covered Securities issuers in the issuer's fund complex; (b) information about differential compensation to the selling broker-dealer on transactions involving (i) securities that have a deferred sales load (subject to certain exceptions) and (ii) securities issued by an affiliate of the broker-dealer; and (c) industry-wide comparative information on loads, service fees, dealer concessions, revenue sharing and brokerage commissions to be published periodically by the SEC. Under the Proposal's point of sale requirements, a broker-dealer would have to provide similar quantitative information regarding distribution-related costs and dealer concessions along with qualitative information about revenue sharing, brokerage commissions and differential compensation, either in writing or orally, subject to certain conditions and exceptions. Customer orders taken prior to delivery of point of sale disclosure would have to be treated as indications of interest until the disclosure was delivered and the customer had the opportunity to cancel the order. The SEC release emphasizes that the requirements in the Proposal, like those in existing Rule 10b-10, would not create safe harbors from the anti-fraud provisions of the federal securities laws or any other legal requirement. Public comment is requested on numerous aspects of the Proposal including whether the Proposal's confirmation and point of sale disclosure requirements should apply to banks that sell Covered Securities. Comments on the Proposal should be received by the SEC within 60 days of the Proposal's publication in the *Federal Register*.

◆ **Basel Committee Issues Technical Papers on Calculation of Cross-Border Operational Risk, Securitizations, and the Treatment of Expected and Unexpected Losses**

In connection with the development of the new Basel Accord ("Basel II"), the Basel Committee on Banking Supervision ("Basel Committee") issued technical papers on home-host recognition of Advanced Measurement Approach ("AMA") operational risk capital (the "Operational Risk Paper"); changes to the securitization framework (the "Securitization Paper"); and modifications to the capital treatment of expected and unexpected credit losses (the "Credit Losses Paper").

Operational Risk Paper. The Operational Risk Paper is intended to address industry concerns about the cross-border implementation of an AMA for operational risk. The Basel Committee is pursuing a "hybrid" approach pursuant to which, subject to supervisory approval, a banking organization would be required to use a stand-alone approach for its *significant* internationally active banking subsidiary, but would be permitted to merely allocate a portion of its group-wide AMA capital requirement for other international subsidiaries. Because the Basel Committee does not believe capital can move freely within a consolidated organization, while a significant subsidiary can use its own diversification benefits to calculate AMA capital, it could not use the group-wide diversification benefits.

Securitization Paper. The Securitization Paper reflects the Basel Committee's attempt to simplify the rules regarding securitizations. In this regard, the Securitization Paper provides that the Basel Committee is

New Subscribers, Past Issues and Background:

If you would like anyone else to receive issues of the *Financial Services Alert*, would like to receive any past issues, or would like the background materials for any of the matters discussed above, please contact **Greg Lyons, Eric Fischer, Elizabeth Shea Fries or Jackson Galloway** at the e-mail addresses referenced at the end of this newsletter.

Disclaimer:

This publication, which may be considered advertising under the ethical rules of certain jurisdictions, is provided with the understanding that it does not constitute the rendering of legal advice or other professional advice by Goodwin Procter LLP or its attorneys.

© 2004 Goodwin Procter LLP. All rights reserved.

Alert on the Web:

A search engine enabling key word searches of back issues of the *Alert* is available at www.goodwinprocter.com/fsa.asp

Goodwin Procter Offices:

Exchange Place
Boston, MA 02109
Tel: (617) 570-1000

103 Eisenhower Parkway
Roseland, NJ 07068
Tel: (973) 992-1990

599 Lexington Ave.
New York, NY 10022
Tel: (212) 813-8800

1717 Pennsylvania Ave., N.W.
Washington, DC 20006
Tel: (202) 974-1000

introducing an Internal Assessment Approach, based on the current approach of some banks, regarding exposures to asset-backed commercial paper conduits. In addition, the Supervisory Paper states that simpler methods than the Supervisory Formula will be available to calculate capital with respect to unrated positions.

Moreover, the Basel Committee is considering adding additional flexibility to the top-down approach with respect to purchased receivables. Fourth, all externally rated positions will be considered under the Ratings-Based Approach, regardless of whether the institution is an investor or originator or where the position is relative to the KIRB threshold. Finally, the Securitization Paper declares that the lowest capital charges will be applied to the most "senior" positions, rather than those that have previously been defined as "thick."

Credit Losses Paper. The Credit Losses Paper confirms that, in response to industry comments, the Basel Committee has decided, with respect to the Internal Ratings-Based approach, to remove expected losses from the risk weight functions. The Credit Losses Paper then details how many of the formulae in the proposed Basel II (e.g., concerning corporate portfolios, specialized lending, and retail exposures) are modified to reflect this change. Moreover, the Credit Losses Paper highlights that banks still are required to compare expected losses with actual provisions. To that extent expected losses exceed actual provisions, the difference is deducted equally from Tier 1 and Tier 2 capital. If actual provisions exceed expected losses, the difference will be added to Tier 2 capital. Initially, the Basel Committee expected to cap this add-on to 20% of Tier 2 capital. However, in response to industry comment that such a limit may encourage banks to limit their actual provisions, the Credit Losses Paper provides that the cap instead will be an as yet undefined percentage of risk weighted assets.

◆ **FDIC Issues Rule Clarifying Insurance Coverage for Living Trust Accounts**

The FDIC issued a final rule (the "Rule") that clarifies and simplifies its deposit insurance coverage rules for living trust accounts ("LTAs"). An LTA is a formal, revocable trust over which the grantor retains ownership during his or her lifetime. Upon the grantor's death, the trust generally becomes irrevocable. LTAs are frequently used to achieve estate planning objectives. The Rule clarifies that the FDIC will allow up to \$100,000 in deposit insurance coverage for each "qualified beneficiary" of an LTA listed as a beneficiary in the living trust. Moreover, the Rule defines a qualified beneficiary as the account owner's spouse, children, grandchildren, parents and siblings. Under the Rule, if a qualifying beneficiary is named in the living trust and the bank indicates in its records that the account is an LTA, the beneficiary will be eligible for insurance coverage. Importantly, the Rule eliminates the previously existing concept that certain "defeating contingencies" (i.e., conditions in the living trust that create a possibility that the beneficiary may never receive the funds after the LTA owner's death) may cancel FDIC deposit insurance coverage. The Rule becomes effective April 1, 2004, but the FDIC will apply the Rule after January 13, 2004 if doing so would benefit LTA holders of a financial institution that failed or fails between January 13, 2004 and April 1, 2004.

◆ **OCC Rules UPS Drop Boxes Do Not Constitute Branches**

The OCC issued an interpretive letter ("Letter 980") declaring that a national bank could maintain UPS drop boxes to receive customer deposit account opening forms and deposits without converting nonbranch financial service facilities into branches. Letter 980 notes that if the bank itself provided the drop-box, pursuant to a 1969 US Supreme Court decision the location of the drop-box likely would be considered a branch. However, since the UPS drop box satisfied the same conditions as the OCC set forth in its rules (7.1012) for a third party messenger service not to be deemed a branch, branches did not exist in this case.

Other Item of Note

◆ **Registered Adviser Trade Group Indicates It Will Draft Model Code of Ethics**

In a letter to the SEC, the Investment Counsel Association of America, a trade group for federally registered advisers, announced that it would draft a model code of ethics for investment advisers designed to assist advisers in complying with new SEC requirements in this area.

Goodwin Procter LLP Financial Services Partners and Counsel

Lynne B. Barr	Melanie L. Fein	Geoffrey R. T. Kenyon	William P. Mayer	William E. Stern
Raymond P. Boulanger	Eric R. Fischer	Thomas J. LaFond	Kathryn I. Murtagh	Meryl E. Wiener
Margaret B. Crockett	Elizabeth Shea Fries	Paul W. Lee	Philip H. Newman	
Peter T. Fariel	Jackson B.R. Galloway	Gregory J. Lyons	Regina M. Pisa	

To e-mail any of the above attorneys, use first initial of first name followed by last name followed by @goodwinprocter.com. For example, Gregory J. Lyons would be glyons@goodwinprocter.com.