Developments of Note

♦ FRB Proposes Continued Inclusion of Trust Preferred Securities in Tier 1 and Tier 2 Capital

The FRB issued a much anticipated proposed rule (the “Proposed Rule”) on May 6, 2004 concerning the inclusion of outstanding and prospective issuances of trust preferred securities in the tier 1 and tier 2 capital of bank holding companies (“BHCs”). The FRB has permitted the inclusion of minority interests in the form of trust preferred securities, or “undated cumulative preferred securities issued out of a special purpose entity, usually in the form of a trust, in which a BHC owns all of the common securities,” in tier 1 capital since 1996. In light of supervisory concerns, domestic and international competitive equity considerations and a new rule issued by the Financial Accounting Standards Board (“FASB”) in January 2003 and revised in December 2003, in which FASB determined that instruments like trust preferred securities should not be consolidated in a BHC’s financial statements under Generally Accepted Accounting Principles, the FRB began a reconsideration of the capital treatment of trust preferred securities and other minority interests, culminating in the Proposed Rule. Under the Proposed Rule, outstanding and prospective issuances of trust preferred securities would continue to be included in the tier 1 and tier 2 capital of BHCs, subject to certain quantitative limits and qualitative standards. Following a three year transition period ending on March 31, 2007, the aggregate amount of cumulative perpetual preferred stock, trust preferred stock and minority interests in the equity accounts of certain consolidated subsidiaries (collectively, “restricted core capital elements”) included in tier 1 capital, net of goodwill, would be limited to 25% of tier 1 capital. Certain restricted core capital elements in excess of the 25% limit would also be included in tier 2 capital, subject to certain limitations. In an effort to align the capital requirements imposed on BHCs operating internationally with a commitment made by the FRB to the other G-10 banking supervisory agencies participating in the Basel Committee on Banking Supervision in 1998 and with the requirements that are likely to be imposed in 2007 under the Proposed New Basel Accord, internationally active BHCs will be expected to limit trust preferred securities and certain other capital elements to 15% of tier 1 capital, net of goodwill. Of particular note, is the proposal to treat trust preferred securities as limited-life preferred stock in the five years before the underlying note matures, with the result that in the last five years of the note the outstanding amount of trust preferred securities will be excluded from tier 1 capital and included in tier 2 capital, subject, together with subordinated debt and other limited-life preferred stock, to 50% of tier 1 capital. Furthermore, during this period, the trust preferred securities will be amortized out of tier 2 capital by one-fifth of the original amount, less redemptions, each year and be completely excluded from tier 2 capital in the note’s last year. Comments are due by July 11, 2004.

♦ SEC Issues No-Action Relief Permitting Three-Tier Master-Feeder Fund Structure with Offshore Conduit

The staff of the SEC Division of Investment Management (the “Staff”) issued a no-action letter providing relief related to Sections 7(d) and 12(d)(1)(E) of the Investment Company Act of 1940, as amended (the “1940 Act”), for a proposed three-tier, master-feeder fund structure designed to avoid “unrelated business taxable income” (“UBTI”) for retirement plan investors in the top-tier feeder fund. The proposed structure featured (i) a bottom-tier master fund (the “Master Fund”), a closed-end fund registered under the 1940 Act, investing in hedge funds and other pooled investment vehicles and taxable as a partnership; (ii) a middle-tier offshore fund (the “Offshore Fund”), investing wholly in securities of the Master Fund; and (iii) a top-tier feeder fund (the “Top-Tier Fund”), a closed-end fund registered under both the 1940 Act and the Securities Act of 1933, as amended, investing wholly in securities of the Offshore Fund and offered exclusively to retirement plans and certain other tax-exempt entities. The structure was designed to permit Top-Tier Fund investors to avoid UBTI from the Master Fund’s investments by interposing the unregistered Offshore Fund between the two U.S. registered funds. The Staff stated that it would not view the Offshore Fund as conducting an illegal indirect offering of the Offshore Fund in the U.S. through the Top-Tier Fund contrary to 1940 Act Section 7(d), based on the following factors, among others: (i) the Top-Tier and Master Funds are registered under the 1940 Act, and the Master Fund’s investment adviser is SEC-registered; (ii) the Top-Tier Fund controls the operations of the Offshore Fund; (iii) the relationship between the Master and Top-Tier Funds is functionally equivalent to the usual two-tiered master-feeder structure; (iv) the Offshore Fund’s assets will at all times be maintained in the U.S. in accordance with the custody requirements of 1940 Act Section 17(f); (v) the Offshore Fund will maintain duplicate books and records at a U.S. office, and the Staff...
will have access to such books and records under 1940 Act Section 31; and (vi) the Offshore Fund will designate its custodian as agent in the U.S. for service of process and will consent to the jurisdiction of U.S. courts and the SEC. The Staff indicated that the proposed structure would comply with 1940 Act Section 12(d)(1)(E), which offers conditional relief from the 1940 Act’s limitations on investment in other investment companies, if, among other things: (A) the Offshore Fund, whose only shareholder is the Top-Tier Fund, must seek and follow voting instructions from Top-Tier Fund shareholders with respect to any Master Fund proxies, and the Top-Tier Fund must seek and follow voting instructions from its shareholders with respect to any Offshore Fund proxies; and (B) the Offshore Fund refrains from substituting securities of the Master Fund except as approved by the SEC pursuant to 1940 Act Section 26.

IRS Issues Guidance Regarding Qualification of Repurchase Agreements as Government Securities under RIC Asset Diversification Tests

The IRS recently issued guidance under which a regulated investment company (a “RIC”) may treat certain repurchase agreements (“repos”) as Government securities in ascertaining whether the RIC has satisfied the asset diversification tests set forth in Section 851(b)(3) of the Internal Revenue Code of 1986, as amended (the “Code”). Rev. Proc. 2004-28 provides that, as long as a repo is “collateralized fully” with Government securities within the meaning of Rule 5b-3(c)(1) of the Investment Company Act of 1940, as amended (the “1940 Act”), a RIC may treat the repo as a Government security for purposes of Code Section 851(b)(3). The IRS emphasized that, in light of the commonality of structure and purpose of the diversification rules applicable to RICs under the Code and the rules set forth in Section 5(b)(1) of the 1940 Act and the need for RICs to comply with both, the two sets of rules should be interpreted consistently.

DOL Issues Final Class Exemption for Investment in Employer Securities by Plans Sponsored by Trust REITs

The Department of Labor (the “DOL”) has issued prohibited transaction class exemption 2004-07 under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), regarding the investment in shares of beneficial interest of real estate investment trusts that are structured as a business trust under state law (each a “Trust REIT”) by 401(k) and other individual account employee benefit plans sponsored by the Trust REIT or an affiliate (each a “Trust REIT Plan”). This class exemption permits a Trust REIT Plan’s acquisition, holding and sale of certain publicly traded shares of beneficial interest in the corresponding Trust REIT (“Qualifying REIT Shares”), including shares that are part of a paired share arrangement, at the direction of either the participant or an independent fiduciary, or pursuant to a plan provision requiring that employer contributions of cash be used to purchase Qualifying REIT Shares. In addition, the class exemption permits an employer’s in-kind contribution of Qualifying REIT Shares to a Trust REIT Plan. The relief provided by the class exemption is subject to a number of significant conditions. Provided the relevant conditions were or are satisfied at the time of the transaction, the class exemption provides both retroactive relief for transactions occurring from April 28, 1998 through June 27, 2004, and prospective relief for transactions occurring after June 27, 2004.

FDIC Issues Comprehensive Guide on FDIC Insurance

The FDIC issued a comprehensive, updated guide entitled FDIC Guide to Deposit Insurance Coverage that explains the FDIC’s deposit insurance rules. The Guide, among other topics, discusses coverage limits, common ownership categories (single accounts, self-directed retirement accounts, joint accounts, revocable and irrevocable trust accounts, employee benefit plan accounts, corporate and partnership accounts and public unit accounts) and coverage requirements. The Guide also provides responses to frequently asked questions concerning, among other things, fiduciary accounts, the effect of the merger of FDIC-insured banks, death of an account owner and how the FDIC determines ownership of accounts.

Goodwin Procter LLP, a firm of 500 lawyers, has one of the largest financial services practices in the United States.