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## DEVELOPMENTS OF NOTE

### **House Financial Services Committee Chairman Barney Frank Introduces the Financial Stability Improvement Act of 2009 to Address Systemic Risk and Other Financial Regulatory Reforms**

House Financial Services Committee Chairman Barney Frank introduced a discussion draft of the Financial Stability Improvement Act of 2009 (the "Act"), which addresses the regulation of systemic risk and the resolution of systemically important financial institutions. The Act also contains important provisions regarding thrift and industrial loan company charters, credit risk retention in connection with securitization transactions and the merger of the OTS into the OCC. The Act incorporates several pieces of the financial regulatory reform legislation proposed by the Obama Administration that were discussed in the [July 28, 2009 Alert](#) and the [August 4, 2009 Alert](#).

The House Financial Services Committee has already held hearings on the Act, which included testimony by the Treasury Secretary and the heads of each of the federal banking

agencies. Chairman Frank has scheduled a markup of the Act next week and hopes to have a vote on the Act as early as this week.

*Financial Services Oversight Council.* The Act would create the Financial Services Oversight Council (the “Council”), which would identify financial companies and financial activities that pose a threat to financial stability, and would subject those companies and activities to heightened prudential oversight, standards and regulation. The Council would also subject systemically important financial market utilities and payment, clearing and settlement activities to heightened oversight, standards and regulation. The Treasury Secretary would serve as the chair of the Council, whose other members would include the Chairman of the FRB, the Comptroller of the Currency, the Director of the OTS until it would be merged into the OCC, the Chairman of the FDIC, the Chairman of the SEC, the Chairman of the CFTC, the Director of the Federal Housing Finance Agency and the Chairman of the National Credit Union Administration. A state insurance commissioner and a state banking supervisor would also serve as non-voting members of the Council for terms of no longer than two years. The Council is designed to have the ability to coordinate responses by these member agencies to mitigate identified threats to financial stability and would annually report to Congress on significant financial market developments and potential emerging threats to the stability of the financial system.

The Council would not conduct examinations or enforce applicable laws with respect to any one institution, but would instead focus on identifying issues that threaten the broader economy. Rulemaking, examination and enforcement authority over systemically important financial institutions would be vested in the FRB. Although the FRB would write and enforce new regulations for systemically important financial institutions, the Council would advise Congress on financial regulation, monitor companies and activities that should be subject to tougher standards and issue formal recommendations that particular agencies should adopt. The federal financial agencies would be required to provide a written explanation to the Council within 60 days following such a recommendation stating the actions it had taken in response to the recommendation or the reason it did not adopt the recommendation. In the event of a dispute among agencies, the Act would allow the Council to make a binding decision. Under the original proposal by the Obama Administration, the interagency council could have advised the FRB or other regulators, but had no power over them.

The Council would not be an agency of the federal government and accordingly would not be subject to the Administrative Procedures Act, Freedom of Information Act or other such statutes governing the procedures of federal agencies. The Act also provides that the Council would not be subject to the Federal Advisory Committee Act. The staff of the Council would be detailed from the Treasury Department and other agencies. Funding for the Council would be provided equally from its voting members.

*Systemic Risk Oversight and Regulation.* The Act subjects financial firms or activities that pose significant risks to the financial system to heightened, comprehensive scrutiny by federal regulators. Such heightened standards would be imposed through a variety of options intended to be tailored to the specific threat posed to the financial system, as opposed to a “one size fits all” approach. The Administration and the House Financial Services Committee stated that regulators’ “inability to see developments outside their narrow ‘silos’ allowed the current crisis to grow unchecked.” Accordingly, the Act is designed to ensure constant communication and the ability to look across markets for potential risks through enhanced information gathering and sharing requirements for the

Council and for all financial regulators, including the SEC and CFTC. The Council and the FRB would have the authority to require the submission of periodic and other reports from any financial company for the purpose of determining whether the company or a financial activity or market it participates in pose a threat to financial stability. The FRB would have the ability to recommend that the other federal financial regulators adopt heightened prudential standards for activities that are identified as posing a threat to U.S. financial stability or to the U.S. economy. The FRB would have back-up authority to step in if regulators do not act quickly to address developing problems identified by the Council.

As discussed above, the Act provides that the FRB would have rulemaking, examination and enforcement authority over systemically important financial institutions. The Act also provides that the FRB would have additional authorities to regulate systemically important payment, clearing and settlement systems. The FRB would be authorized to prescribe risk management standards for systemically important financial institutions and, after consulting with the Council and the relevant supervisory agency, for systemically important payment, clearing and settlement systems conducted by financial institutions. The Act would give the FRB the power to direct any large financial holding company to sell or transfer assets, or stop certain activities if the FRB determined there could be a “threat to the safety and soundness of such company or to the financial stability of the United States.” The FRB would have the power to impose risk-based capital requirements, leverage limits, liquidity and concentration requirements. Such concentration requirements would prohibit systemically important financial institutions from having credit exposure to an unaffiliated company that exceeds 25 percent of the institution’s capital stock and surplus, or a lower level if the FRB determines it to be prudent. Treasury Secretary Timothy Geithner stated in his testimony before the House Financial Services Committee that such heightened standards “would provide strong incentive for these firms to shrink, simplify and reduce their leverage.” The FRB could also recommend that the primary federal regulator for any subsidiary of a financial holding company raise capital standards and take other actions. If the agency did not comply with such recommendation, it would have to provide a written explanation to the FRB and the Council within 60 days. The FRB would also have the power to place any systemically important financial institution it determines to be critically undercapitalized into bankruptcy.

The Act does not provide specific requirements that would subject a financial company to heightened prudential standards. Rather, the Council may subject any financial company to heightened prudential standards if it determines that material financial distress at the company or the nature, scope or mix of the company’s activities could pose a threat to financial stability of the economy. The heightened prudential standards could also be imposed on a foreign financial company that owns or controls a federal or state branch, subsidiary or operating entity that is identified as being systemically significant. When determining whether a company should be subject to the heightened prudential standards, the Act provides that the Council should consider (i) the amount and nature of the company’s financial assets; (ii) the amount and nature of the company’s liabilities, including the degree of reliance on short-term funding; (iii) the extent and nature of the company’s off-balance sheet exposures; (iv) the extent and nature of the company’s transactions and relationships with other financial companies, (v) the company’s importance as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system; (vi) the nature, scope and mix of the company’s activities; and (vii) any other factors that the Council deems appropriate. The Council would periodically review the list of systemically important financial institutions to determine whether they should remain subject to heightened prudential standards.

The Act prohibits the disclosure of the identity of the systemically important financial institutions subject to these heightened standards. However, many commentators have noted that those institutions which are publicly-held would probably have to disclose that they are subject to the heightened prudential standards under the SEC's reporting requirements. In his testimony before the House Financial Service Committee, FRB Governor Daniel Tarullo noted that "through some disclosure to shareholders and analysts, it's likely most, if not all institutions, will be known to the public." Secretary Geithner agreed, stating that "[i]t won't be a secret that they're held to tougher standards, it's very important that they are held to the tougher standards and you know that they're held to tougher standards." Chairman Frank, however, observed that the disclosure of the identity of those institutions would exacerbate moral hazard. "There's the argument that, once people know that certain institutions are of a certain size, they'll be protected," he said; "[t]hat's why many of us rejected the notion that there be a list published beforehand."

*Consolidated Regulation of Bank Holding Companies.* The Act is designed to consolidate regulation of bank holding companies to prevent companies from avoiding regulation under the Bank Holding Company Act of 1956, as amended (the "BHCA"). The Act would remove the Gramm-Leach-Bliley Act restraints on the FRB's authority over companies subject to consolidated regulation and would provide specific authority to the FRB and other federal financial agencies to regulate bank holding companies for financial stability purposes and to address potential problems.

*Supervision of Thrifts.* Under the Act, in an attempt to prevent "regulatory arbitrage" the OTS would be merged into the OCC within one year of the Act's enactment. Unlike the Administration's proposal, the Act preserves the mutual and stock thrift charters, which would be regulated under a new division of the OCC headed by a deputy comptroller. Savings and loan holding companies would be supervised by the FRB. All functions of the OTS relating to the supervision and regulation of state savings associations would be transferred to the FDIC. The Act provides that federal mutual holding companies would be allowed to elect to waive dividend payments to the top tier mutual interest. The seat on the Board of the FDIC, which is currently held by the Director of the OTS, would be transferred to the Chairman or a Governor of the FRB.

*Industrial Loan Companies and Non-bank Banks.* The Act would close exemptions in the BHCA for industrial loan companies and other non-bank financial institutions. Commercial enterprises that currently own thrifts, non-bank banks, industrial loan companies, and other similar financial institutions but are not currently subject to bank holding company regulation would not have to divest such financial institutions, but would have to be restructured to create an intermediate bank holding company to hold all financial activities and would face limits on transactions between the bank holding company and any commercial affiliates. Companies would have 90 days following the enactment of the Act to restructure or register as a bank holding company. If a company does not comply within 90 days, which the FRB could extend by an additional 180 days, it would have 180 days to divest its financial institution. Going forward, the Act would prohibit any additional commercial companies from owning banks, thrifts, industrial loan companies, or other specialty bank charters.

*Credit Risk Retention for Securitizations.* The Act directs the federal banking regulators and the SEC to write rules jointly requiring creditors to retain ten percent or more of the credit risk associated with any loans that are transferred or sold, including for the purpose of securitization. The regulators would be permitted to adjust the level of risk retention above

or below ten percent, but could not adjust such level below five percent. In the case of securitizations that are not originated by creditors, regulators would require the securitizer to retain the credit risk.

*Resolution of Systemically Important Financial Institutions.* The Act provides for the orderly resolution of failing systemically important financial institutions to ensure that the stability of the overall financial system is protected and is intended to end the idea that some institutions are “too big to fail.” The Act provides that, following a determination by the Treasury Secretary, the FDIC would resolve failing systemically important financial institutions in order to unwind existing contracts, address creditors’ claims, and ensure that parties required to bear losses do so. Under the Act, the Treasury Secretary could only make the determination to resolve a systemically important financial institution for the purpose of financial stability, not to preserve that particular institution. The Act also provides for the removal of the management responsible for the failure of the institution. The Act is designed to create a more flexible resolution process that would help prevent contagion and disruption to the entire system and the overall economy unlike traditional bankruptcy, which the Administration and Chairman Frank believe does not account for complex interrelationships of such large financial firms and may endanger financial stability. The Act also provides that systemically important financial institutions would be required to prepare resolution plans that would have to be updated annually.

Costs associated with the resolution of systemically important financial institutions would be repaid first from the assets of the failed firm at the expense of shareholders and creditors and, to the extent of any shortfall, from assessments on financial firms with assets of \$10 billion or more. The Administration has indicated that such assessments would be levied over a flexible repayment period to avoid the potential procyclical effect of such assessments. In her testimony to the House Financial Services Committee, FDIC Chairman Sheila Bair argued that a permanent resolution fund managed by the FDIC should be established, similar to the Deposit Insurance Fund, which would be pre-funded by regular risk-based assessments on financial institutions with assets of at least \$10 billion. Chairman Frank has stated that he will offer an amendment providing for up-front assessments on financial institutions with assets of over \$10 billion. Secretary Geithner has reiterated his opposition to such up front assessments. Chairman Bair further argued that such a resolution fund should be authorized to borrow from the Treasury Department and any borrowings would be repaid by the financial institutions that must contribute to the resolution fund.

*Limits on Section 13(3) of the Federal Reserve Act.* The Act would require the FRB to obtain the prior written consent of the Secretary of the Treasury before it provides temporary liquidity assistance pursuant to section 13(3) of the Federal Reserve Act. Such assistance would be confined to generally available facilities rather than assistance to a particular financial institution and would only be used to provide liquidity to solvent institutions during period of severe stress in the financial markets or the U.S. economy. In his testimony to the House Financial Services Committee, Governor Tarullo emphasized the importance of the FRB, “as the nation’s central bank, [to] retain its longstanding authority to address broader liquidity needs within the financial system under section 13(3) when necessary to maintain financial stability.”

## Massachusetts Releases Final Data Security Rule

On October 30, 2009, the Massachusetts Office of Consumer Affairs and Business Regulation filed final amendments to the Commonwealth's data security rules, set forth in 201 CMR 17.00 (the "Rules"). The Rules impose significant requirements on those possessing personal information of state residents.

Most provisions in the Rules are identical to the proposed rules released on August 17, 2009. The effective date of the Rules remains March 1, 2010. Changes from the proposed version of the Rules include the following:

- The definitions of a "Service Provider" and an entity that "owns and licenses" personal information now include persons that "store" personal information. The definitions in the proposed rules previously included persons that "maintain" personal information, so this change appears to be a clarification.
- The proposed rules stated that entities must contractually require third-party service providers to implement and maintain appropriate security measures, but grandfathered existing contracts entered into before March 1, 2010. The final Rules maintain this provision but clarify that the contract must be entered into no later than March 1, 2010 and that the grandfather provision is valid until March 1, 2012.

Since their original release in September 2008, the Rules have been amended twice and their effective date repeatedly has been delayed. The Rules were most recently amended on August 17, 2009 and a public hearing on the Rules was held on September 22, 2009. (See the Goodwin Procter Alerts of [September 29, 2008](#), [February 13, 2009](#), and [August 19, 2009](#).)

## Goodwin Procter Sponsors Third Annual Private Equity Investing in Banks Symposium

The Third Annual Private Equity Investing in Banks Symposium was held at the University Club in New York City on October 27, 2009. The symposium was sponsored by Goodwin Procter and presented by the *American Banker*, *Investment Dealers' Digest* and *Mergers and Acquisitions*. It featured a top roster of speakers from the private equity, banking, and legal industries who examined whether the momentum behind private equity investments in banks is sustainable. Thomas LaFond, a partner in Goodwin Procter's Financial Services Group and the chair of Goodwin Procter's banking practice area, provided opening remarks. James Lockhart, the vice chairman of WL Ross & Co., delivered the keynote address, which was followed by an interview with Donald Marron, the Chairman and Chief Executive Officer of Lightyear Capital. William Stern, a partner in Goodwin Procter's Financial Services Group, offered insights into the regulatory environment for private equity investments in banks, including the FDIC's policy statement on private equity investments in failed banks. The symposium concluded with a panel discussion moderated by Michael Kendall, a partner in Goodwin Procter's Private Equity Group, that included Richard Decker, Chairman and Co-Founder of Belvedere Capital, David King, Senior Managing Director of Irving Place Capital, Nicholas Lazares, Chairman and Chief Executive Officer of Federal One Holdings LLC, and Brian Shortsleeve, a Principal of General Catalyst.

A number of themes emerged during the symposium. All of the speakers noted the importance of management when investing in banks. Having a strong management team was considered the key to a successful private equity investment in a bank. Other important factors highlighted by the speakers included selecting the proper geographic location and having the expertise and technology to assess properly credit quality and troubled assets. William Stern highlighted the regulatory drivers behind the recent popularity of club deals for investing in financial institutions. The panel discussed the challenges of putting together such club deals, including how to find the right partners for the club and the importance of sharing the same strategic vision for the bank. In addition to partnership among investors, the speakers emphasized the importance of developing good partnerships with the banking regulators and how long term private equity investors and regulators often share the same goals. All of the participants in the symposium agreed that great opportunities exist for private equity investment in banks. As Nicholas Lazares said, such opportunities are dependent on a variety of components coming together at precisely the right moment, “the bank, the management and the capital must all come together at exactly the right time, just like making a soufflé.”

### **OCC Allows Use of Collectively Owned LLCs for Banks' OREO**

In [Interpretive Letter No. 1123](#), the OCC permitted a national bank to exchange its participation interest in other real estate owned (“OREO”) acquired in satisfaction of debt for an interest in an LLC formed with other participants to hold that OREO. The bank had participated in a syndicated loan to two residential real estate developers that was collateralized by residential real estate developments. The syndicate foreclosed on the properties after the developers filed for bankruptcy.

The OCC approved the bank’s proposal based on the argument that, because an interest in the LLC would be more marketable than an interest in the underlying real estate, each of the banks in the arrangement would be better able to dispose of its interests in the properties and recover loan losses. In addition, rather than managing the properties according to the complex and burdensome terms of the loan documents, aggregation of the banks’ interests in the LLC would allow the banks to designate one institution, the LLC’s managing member, to more efficiently address the day-to-day responsibilities of holding, managing, and negotiating the disposal of the properties.

Interpretive Letter No. 1123 is one of two rulings by the OCC on LLC interests this year and continues a history of the OCC facilitating the structuring of OREO disposition strategies by banks when undertaken in good faith to improve the banks’ ability to recover or limit loan losses on OREO. (A prior example is the OCC’s Interpretive Letter No. 395 (1987) permitting an exchange of OREO for non-voting convertible preferred stock in a publicly traded real estate company.) The other ruling on LLC interests from this year is [Interpretive Letter No. 1118](#), where the OCC permitted a bank to exchange its interest in OREO consisting of townhouse units for a 22.7% interest in an LLC that would hold the bank’s townhouse units as well as the remaining townhouse units in the same complex that had been foreclosed upon by other banks that would likewise hold interests in the LLC.

Under both recent interpretive letters, the OCC’s grant of permission is subject to the following conditions:

- Prior to making the exchange, the bank's directors must determine that the exchange is in the best interests of the bank and would improve its ability to recover, or otherwise limit, its loan loss. The bank must document the basis for this determination.
- The bank must provide prior written notice to the bank's OCC supervisory office, which must then issue a notice of "non-objection" based on its evaluation of the bank's risk management systems and controls and any other relevant supervisory considerations.
- The bank must not further exchange the LLC interests for an interest in any other real or personal property, which reflects the OCC's longstanding position allowing only a single exchange under similar circumstances in order to deter speculation (the "single exchange rule").
- The bank must ensure that the LLC complies with OCC's OREO regulations, including the requirement to obtain a current appraisal on OREO properties.

The bank's holding of the LLC interests is subject to a 5 year limit, extendable by the OCC for up to 5 additional years

### **Bank Pleads Guilty in First Criminal Prosecution Based on Failure to File CTRs**

In the first criminal prosecution of a bank for failure to meet federal currency transaction reporting requirements, Family Bank and Trust Co. ("Family Bank") pleaded guilty to charges that it had conspired with its former chief executive officer and others by failing to file currency transaction reports ("CTRs") after receiving large cash deposits from members of a drug trafficking ring. As described in the Justice Department's [press release](#), Family Bank and members of its management knowingly and willfully failed to file CTRs on large cash deposits totaling more than \$800,000 that the bank received between March and August 2001. To conceal the relationship between the depositors and the transactions and to give the appearance of legitimate deposits, the bank agreed to open several accounts in the names of multiple nominees and businesses.

Under the plea agreement, Family Bank will forfeit \$800,000 and relinquish any claims to \$2.1 million previously seized by the government in pursuing the drug trafficking ring. A long-standing shareholder will pay \$500,000 of the money forfeited by the bank and serve two years' probation.

### **Bank Regulators Issue Policy Statement on Workouts of Commercial Real Estate Loans**

The FRB, FDIC, OCC, OTS, NCUA and the Federal Financial Institutions Examination Council State Liaison Committee (collectively, the "Bank Regulators") jointly issued guidelines on commercial real estate workouts entitled "*Policy Statement on Prudent Commercial Real Estate Loan Workouts*" (the "Policy Statement"). The Policy Statement updates and replaces the Bank Regulators' existing guidelines on this topic and provides guidance for financial institutions and bank examiners who are addressing issues concerning commercial real estate ("CRE") loan borrowers who are "experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in

selling or renting commercial properties.” The Policy Statement is designed to provide illustrations of sound risk management practices for CRE loan workouts.

The Bank Regulators recognize that in these difficult economic times, it is often preferable for financial institutions to restructure troubled CRE loans rather than to foreclose on the borrower. The Policy Statement declares that banks that “implement prudent loan workout arrangements after performing comprehensive reviews of borrowers’ financial condition will not be subject to criticism for engaging in these efforts even if the restructured loans have weaknesses that result in adverse credit classifications.” Moreover, performing loans made to creditworthy borrowers will not be downgraded simply because of a decline in the value of the underlying collateral. In an extensive attachment to the Policy Statement, the Bank Regulators provide detailed examples of how the guidance should be applied to CRE workouts.

### **SEC Staff Issues Additional Guidance on the Treatment under Rule 14a-8 of Stockholder Proposals Relating to Risk and Stockholder Proposals Addressing CEO Succession Planning**

The staff of the SEC’s Division of Corporation Finance issued [Staff Legal Bulletin No. 14E](#) (“SLB 14E”), which provides additional guidance on Rule 14a-8 under the Securities Exchange Act of 1934. Rule 14a-8 gives stockholders the opportunity to place a proposal in a company’s proxy materials for consideration at an annual or special meeting of stockholders, provided certain procedural requirements are met and the proposal does not fall within one of the categories of proposals that the Rule allows a company to exclude. SLB 14E revises the staff’s historical position under which an issuer could generally exclude a shareholder proposal relating to an evaluation of risk or a shareholder proposal involving CEO succession planning matters, in each case in reliance on Rule 14a-8’s exclusion for matters relating to an issuer’s ordinary business operations. Going forward, the staff will analyze whether proposals regarding risk evaluation fall within the ordinary business operations exclusion based on whether the underlying subject matter involves a matter of ordinary business to the issuer. As to proposals relating to CEO succession, SLB 14E indicates that because CEO succession planning raises a significant policy issue regarding an issuer’s governance, a proposal that focuses on CEO succession planning generally will not fall within the ordinary business operations exclusion. SLB 14E also provides that a company or a shareholder proponent that intends to submit correspondence in connection with a no-action request may notify the SEC staff of its intention, and is encouraged to provide a targeted date of submission.

### **OTHER ITEMS OF NOTE**

#### **Supreme Court Hears Oral Argument for Review of Seventh Circuit Decision in Harris Associates**

On November 2, 2009, the U.S. Supreme Court heard oral argument in its review of the decision by the U.S. Court of Appeals for the Seventh Circuit in *Jones v. Harris Associates L.P.*, 527 F.3d 627 (7th Cir. 2008), an excessive fee suit under Section 36(b) of the Investment Company Act of 1940. (For background on this case, see the [March 10, 2009](#) and [June 3, 2008 Alerts](#).) The Supreme Court has posted a [transcript](#) of the oral argument on its website.

## **FTC Postpones Compliance Date of Identity Theft Red Flags Rule Until June 1, 2010**

On October 30, 2009, the FTC postponed the compliance date for its Identity Theft Red Flags Rule (16 CFR 681) from November 1, 2009 until June 1, 2010, at the request of “members of Congress,” according to an FTC statement. On October 30, 2009, the U.S. District Court for the District of Columbia ruled that the FTC may not apply the Identity Theft Red Flags Rule to attorneys. The FTC indicated in its [announcement](#) that the postponement would not affect the timeline of that proceeding and any possible appeals, nor would it affect other federal agencies’ ongoing enforcement of corresponding identity theft program regulations.

## **Goodwin Procter Issues Client Alert on House Legislation Regulating Derivatives Trading**

Goodwin Procter has issued a [Client Alert](#) analyzing separate bills approved by the House Financial Services Committee and the House Agriculture Committee, each of which would create a new regulatory regime for derivatives trading. The Client Alert also compares these bills to the U.S. Treasury’s proposed OTC derivatives legislation issued in August 2009 (discussed in Goodwin Procter’s [August 27, 2009 Client Alert](#)).

## **FRB’S Temporary Exemption from Section 23A Restrictions for Funding to Replace Tri-Party Repo Market Funding Expired on October 30, 2009**

The FRB terminated the availability of its temporary exemption from the limitations of Section 23A of the Federal Reserve Act that had temporarily allowed all insured depository institutions to provide liquidity to their affiliates for assets generally funded in the tri-party repurchase agreement (“repo”) market. The FRB instituted the temporary exemption on September 14, 2008 as a response to the financial crisis and to the weakness in the tri-party repo market. The temporary exemption, which was extended on January 30, 2009 expired on October 30, 2009 and the FRB stated that, “the functioning of the tri-party repo market has improved considerably [since January 2009].”

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