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In this Issue:

Developments of Note

- SEC Proposes Rule to Curtail “Pay to Play” Practices by Investment Advisers Seeking to Manage Money for State and Local Governments
- Treasury Submits Proposed Legislation for Various Elements of Financial Regulatory Reform Program
 - Proposed Legislation on Consolidated Supervision and Regulation of Large, Interconnected Financial Firms
 - Proposed Legislation to Establish National Bank Supervisor; Terminate Federal Thrift Charter
 - Proposed Legislation to Revise Certain Changes to Statutory Framework for BHCs and Banks
 - Proposed Legislation Creating Office of National Insurance
 - Proposed Legislation for Public Company Executive Compensation Reform
- Appeals Court Sends Fixed Index Annuity Rule Back to the SEC

Other Item of Note

- Federal Banking Agencies Issue Final Revisions to Flood Insurance Q&As

DEVELOPMENTS OF NOTE

SEC Proposes Rule to Curtail “Pay to Play” Practices by Investment Advisers Seeking to Manage Money for State and Local Governments

The SEC voted to propose a rule intended to curtail “pay to play” practices where an investment adviser makes political contributions or hidden payments to influence government officials to select the adviser to manage money on behalf of public pension plans, retirement plans and 529 plans. This summary is based on the SEC press release announcing the proposed rule. A future edition of the *Alert* will discuss the proposing release once it becomes available.

The proposed rule would, among other things:

- Prohibit direct political contributions by investment advisers (including certain of their executives and employees) to elected officials or candidates (or their associates), subject to certain *de minimis* exceptions;
- Bar an investment adviser who makes a political contribution to an elected official (or candidate) in a position to influence the selection of the investment adviser from providing advisory services for compensation, either directly or through a fund, for two (2) years;

- Prohibit an investment adviser from soliciting contributions to an elected official (or candidate) who can influence the selection of the investment adviser and from soliciting payments to a political party of the state or locality where the investment adviser is seeking to provide advisory services to the government;
- Prohibit an investment adviser from paying a third party (*e.g.*, a solicitor or placement agent) to solicit a government client on behalf of the investment adviser; and
- Prohibit an investment adviser from directing or funding contributions through third parties such as spouses, lawyers or companies affiliated with the investment adviser if that conduct would violate the rule if the investment adviser engaged in such conduct directly.

Treasury Submits Proposed Legislation for Various Elements of Financial Regulatory Reform Program

The Obama Administration, through the Treasury, has been releasing the text of proposed legislation for various elements of its financial regulatory reform program (the “Program”) as they are submitted to Congress. The proposed legislation provides significant detail concerning many segments of the Program described in the Treasury’s White Paper issued in June 2009 (as discussed in the [June 23, 2009 Alert](#).) The proposed legislation on hedge fund adviser registration was described in the [July 21, 2009 Alert](#). Some portions of the proposed legislation concerning the Program are described in this issue of the *Alert*. Other segments will be summarized in future issues of the *Alert*. As reported in the financial press, there is significant Congressional and industry opposition to certain elements of the Program (*e.g.*, the elimination of the thrift charter, the selection of the Board of Governors of the Federal Reserve System as the systemic risk regulator and the establishment of a Consumer Financial Protection Agency), and some or all of the elements of the Program may not be enacted. The Treasury, however, is reportedly continuing to pursue these initiatives in their current form. The *Alert* will continue to cover developments in this area.

Proposed Legislation on Consolidated Supervision and Regulation of Large, Interconnected Financial Firms

As part of its financial regulatory reform program, the Obama Administration, through the Treasury, submitted to Congress [proposed legislation](#) regarding the consolidated supervision and regulation of large, highly leveraged and substantially interconnected financial companies. As noted in the proposed legislation, the inadequate consolidated supervision and regulation of such companies was a key contributor to the recent financial crisis. Accordingly, in order to mitigate systemic risk and promote the stability of the U.S. financial system, the proposed legislation authorizes the Board of Governors of the Federal Reserve System (the “FRB”) to designate certain large, highly leveraged, and substantially interconnected financial companies as “Tier 1 Financial Holding Companies” (or “Tier 1 FHCs”) and to subject such companies to comprehensive and robust prudential supervision and regulation. The proposed legislation is designed to implement recommendations made in the Treasury’s June 2009 White Paper on financial regulatory reform (as discussed in the [June 23, 2009 Alert](#)).

Designation of Tier 1 FHCs. Pursuant to the proposed legislation, the FRB may designate any U.S. financial company as a Tier 1 FHC if it determines that material financial distress

at such company could pose a threat to global or U.S. financial stability or to the global or U.S. economy. In making these determinations, the FRB will look at a number of factors, including the amount and nature of a company's assets and liabilities, its off-balance sheet exposures, the extent of the company's transactions and relationships with other major financial companies, and 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. Similarly, the FRB may designate any foreign financial company as a Tier 1 FHC if it determines that material financial distress at such company could pose a threat to U.S. financial stability or the U.S. economy, taking into consideration the principles of national treatment and equality of competitive opportunity and the amount of the foreign company's U.S. assets, the leverage used to fund activities and operations in the U.S., and other criteria related to the company's U.S. activities and operations. Notably, the proposed legislation does not limit Tier 1 FHCs to institutions that own banking enterprises, or to domestic financial institutions. A designation as a Tier 1 FHC is subject to reevaluation, rescission, notice and an opportunity to be heard.

The proposed legislation provides that the FRB may require any U.S. financial company that has: (i) \$10 billion or more in assets; (ii) \$100 billion or more in assets under management; or (iii) \$2 billion or more in gross annual revenue, to submit information for the purpose of determining if such company is a Tier 1 FHC. Similarly, the FRB may collect information for the same purposes from any foreign financial company that has: (a) \$10 billion or more in assets in the U.S.; (b) \$100 billion or more in assets under management in the U.S.; or (c) \$2 billion or more in gross annual revenue in the U.S. In collecting such information, the FRB must coordinate with any applicable federal regulatory agencies. In addition, if necessary, the FRB may conduct a limited examination of any U.S. financial company for the purpose of determining whether to designate the company as a Tier 1 FHC. Despite criticism from various members of Congress as well as other federal regulators, the proposed legislation provides that, while the Financial Services Oversight Council (the "Council"), which would be created under Title I of the proposed legislation, will have the ability to recommend that certain firms be designated as Tier 1 FHCs, the final determination will rest solely with the FRB.

Prudential Standards. The proposed legislation provides that the FRB shall prescribe, after consultation with the Council, prudential standards for Tier 1 FHCs that will be more stringent than the standards applicable to bank holding companies to reflect the potential risk posed to financial stability by Tier 1 FHCs. Such prudential standards must include: (1) risk-based capital requirements; (2) leverage limits; (3) liquidity requirements; and (4) overall risk management requirements. These standards will be set with a focus on the risks that these firms could pose to the financial system as a whole, not just the risks to each institution. The FRB may differentiate among Tier 1 FHCs taking into consideration their risk, complexity, the financial activities of the institution and its subsidiaries, as well as any other factors the FRB deems appropriate.

Reporting. The FRB may require a Tier 1 FHC to submit various reports, including with regard to: (i) its plan for rapid and orderly resolution in the event of severe financial distress; (ii) the nature and extent to which the Tier 1 FHC has credit exposure to other Tier 1 FHCs; and (iii) the nature and extent to which other Tier 1 FHCs have credit exposure to the Tier 1 FHC. The proposed legislation requires the FRB to use existing reports required by other federal regulatory agencies for these purposes whenever possible.

Supervision/Examination. The proposed legislation also gives the FRB the authority to supervise and examine a Tier 1 FHC and all of its subsidiaries, including backstop authority over functionally regulated subsidiaries, and also gives the Federal Deposit Insurance Corporation (the “FDIC”) back-up authority over Tier 1 FHCs. The FRB may also prescribe, examine and enforce more stringent prudential standards on functionally regulated subsidiaries of Tier 1 FHCs if the FRB determines it is necessary or appropriate to prevent or mitigate risks to financial stability.

Activities. Under the proposed legislation, all Tier 1 FHCs would need to be, at all times, well capitalized and well managed, and they would be subject to the nonfinancial activities restrictions of the Bank Holding Company Act of 1956, as amended (the “BHC Act”). Those Tier 1 FHCs that were not previously subject to the BHC Act would have five years to conform to these activity restrictions. During this phase-in period, any U.S. Tier 1 FHC which is engaged predominantly in activities which are not financial in nature must establish and conduct its financial activities through a single intermediate holding company, which would be subject to the affiliate transaction restrictions and limitations of Sections 23A and 23B of the Federal Reserve Act. A Tier 1 FHC must also provide prior notice to the FRB before engaging in a large acquisition. In considering whether to approve such an acquisition, the FRB will consider, in addition to other factors, the extent to which the proposed acquisition would result in greater or more concentrated risks to global or U.S. financial stability or the global or U.S. economy.

Corrective Action. The proposed legislation subjects all Tier 1 FHCs to a prompt corrective action regime similar to what is now required for federally insured depository institutions, with capital standards including a leverage limit and a risk-based capital requirement. The FRB must closely monitor any undercapitalized Tier 1 FHC, which must submit a capital restoration plan to the FRB. The FRB may require recapitalization and restrict other activities of a significantly undercapitalized U.S. Tier 1 FHC. Furthermore, a critically undercapitalized U.S. Tier 1 FHC must file for bankruptcy within 90 days of becoming critically undercapitalized, or the FRB must file a petition for bankruptcy against such Tier 1 FHC within that time.

Concentration Limits. The proposed legislation requires the FRB to prescribe concentration limit regulations in order to limit the risks that the failure of any company could pose to a Tier 1 FHC and to the stability of the U.S. financial system. Such regulations must prohibit each Tier 1 FHC from having “credit exposure” (which the proposed legislation defines broadly) to any unaffiliated company that exceeds 25% of the Tier 1 FHC’s capital stock and surplus or such lower amount as the FRB may determine to be necessary to mitigate risks to financial stability.

Proposed Legislation to Establish National Bank Supervisor; Terminate Federal Thrift Charter

As part of its financial regulatory reform program, the Obama Administration, through the Treasury, submitted [proposed legislation](#) to Congress entitled the “Federal Depository Institutions Supervision and Regulation Improvements Act of 2009,” which would establish a new bank regulatory agency, the National Bank Supervisor (the “NBS”), through the consolidation of the Office of the Comptroller of the Currency (the “OCC”) and the Office of Thrift Supervision (the “OTS”), and would terminate the federal thrift charter and the thrift holding company framework. In addition, the Treasury stated that the proposed legislation would “remove one of the central sources of arbitrage in the bank regulatory

system.” The proposed legislation includes provisions designed to eliminate or reduce significantly the differences in bank regulatory fees charged by the bank regulatory agencies, and to lower the fees imposed on community banks. The proposed legislation is designed to implement recommendations made in the Treasury’s June 2009 White Paper on financial regulatory reform (as discussed in the [June 23, 2009 Alert](#)).

National Bank Supervisor. The proposed legislation establishes the NBS, as a bank regulatory agency headed by a director (the “Director”) who is appointed by the President with the advise and consent of the Senate. The Director would have a five-year term. Moreover, the OCC and OTS would be consolidated into the NBS, and the NBS would gain by transfer all of the powers, duties and functions of the OCC (other than the consumer financial protection functions, which would be transferred to a new Consumer Financial Protection Agency (the “CFPA”). The NBS would also gain by transfer most of the powers, duties and functions of the OTS (other than the consumer financial protection function transferred to the CFPA and the OTS functions related to state savings associations, which would be transferred to the Federal Deposit Insurance Corporation (the “FDIC”). The consolidation and transfer of the OCC and the OTS into the NBS would occur one year after enactment of the proposed legislation (the “Transfer Date”) and the OCC and OTS would be abolished 90 days after the Transfer Date.

Termination of Federal Thrift Charter. Under the proposed legislation, within six months of its enactment, each federal savings association (“FSA”) would have to notify the OTS, OCC and NBS whether the FSA elects to be: (1) a national bank; (2) a mutual national bank; (3) a state bank; or (4) a state savings association. FSAs or others that convert their charter in connection with the proposed legislation will generally have three years to conform their activities to the requirements of the new charter. In addition, the proposed legislation authorizes the grant of a mutual national bank charter by the NSB either by the grant of a *de novo* charter or through the conversion of a stock-form national bank, a stock-form state bank, a state mutual bank or a credit union, to a national mutual bank.

Furthermore, the proposed legislation provides that, except as otherwise provided in federal law, the NBS, the Board of Governors of the Federal Reserve System (the “FRB”) and FDIC may not adopt or enforce corporate governance regulations that contravene the corporate governance rules of applicable state law unless the NBS, FRB or FDIC find that “Federal regulation is necessary to assure the safety and soundness of the state bank.”

Bank Regulatory Fees. The proposed legislation requires the FRB, FDIC and NBS to adopt joint rules on bank regulatory fees that are designed “to end arbitrage between regulators based on bank examination fees.” Under the proposed legislation, “[b]anks over \$10 billion in assets will pay bank examination fees regardless of charter based on their size, complexity and financial condition.” The proposed legislation would also, in general, reduce the fees paid by smaller banks. Banks with less than \$10 billion in assets would not be assessed fees related to the function of the systematic risk regulator.

Proposed Legislation to Revise Certain Changes to Statutory Framework for BHCs and Banks

As part of its financial regulatory reform program, the Obama Administration, through the Treasury, submitted [proposed legislation](#) to Congress entitled the “Bank Holding Company and Depository Institution Regulatory Improvements Act of 2009” that would make various changes to the statutory framework governing regulations of bank holding companies

("BHCs") and banks. The proposed legislation includes provisions that would result in a wider range of institutions being subject to the Board of Governors of the Federal Reserve System's ("FRB") jurisdiction as BHCs and expanded supervisory authority for the FRB. Other provisions would raise standards for BHCs that seek to become financial holding companies ("FHCs") or to make interstate bank acquisitions. The proposed legislation would enhance requirements for transactions between banks and their affiliates and tighten lending limits by applying such limits to derivatives, repurchase agreements, and securities lending and borrowing transactions and subjecting such transactions to limits on lending to insiders. In addition, the proposed legislation would restrict the ability of troubled banks to engage in regulatory arbitrage by converting charters and make certain other changes to the statutory framework governing BHCs and depository institutions. As explained below, certain of these amendments would implement specific recommendations made in the Treasury's June 2009 White Paper (see the [June 23, 2009 Alert](#)), while others introduce additional tools to address the White Paper's concerns.

Bank Holding Companies and FRB Authority. The proposed legislation would amend the Bank Holding Company Act (the "BHC Act") to eliminate exceptions from the definition of "bank holding company" for institutions that control credit card banks, industrial loan companies, limited purpose trust companies, and grandfathered "nonbank" banks. This amendment, which addresses the White Paper's objective of closing loopholes in the BHC Act, would affect a number of institutions which currently rely on such restrictions to own banking institutions without being subject to the requirements of the BHC Act and the FRB's jurisdiction. Such institutions would have 90 days from the enactment of the statute to register as BHCs with the FRB.

To address the concern raised in the White Paper regarding impediments to the FRB's ability to obtain information from or impose prudential regulations on BHC subsidiaries, the proposed legislation would enhance the FRB's supervisory authority over functionally-regulated subsidiaries of BHCs for which the FRB is not the primary regulator (*i.e.*, national banks, state-chartered nonmember banks, SEC-registered broker-dealers, investment companies, and investment advisers, and CFTC-registered futures commission merchants, commodity trading advisors, and commodity pool operators). The FRB's authority would be expanded by eliminating the BHC Act's restrictions on the FRB's examination, rulemaking and enforcement power over functionally-regulated subsidiaries. The proposed legislation also would clarify the FRB's rulemaking authority under the BHC Act includes authority to adopt rules governing the capital levels of BHCs.

In addition, a new criterion would be added to the factors the FRB must consider in approving a company's acquisition of a bank (thereby making the company a BHC) that is focused on the systemic impact of the transaction. In addition to the factors that the FRB currently must consider, such as competitive factors, financial and managerial resources, and supervisory considerations, the FRB would be required to consider "the extent to which the proposed acquisition, merger or consolidation would result in greater or more concentrated risks to the stability of the United States financial system or the economy of the United States."

Standards for Financial Holding Companies and Interstate Bank Acquisitions. Under the proposed legislation, the standards for BHCs that seek to become FHCs would be raised, implementing a concept from the White Paper that capital and management requirements for FHCs should not be limited to subsidiary depository institutions. A BHC that wishes to become an FHC, and therefore exercise expanded powers, would be required to be

well-capitalized and well-managed. Under existing law, the well-capitalized and well-managed requirements apply to depository institution subsidiaries of the BHC, but not the BHC itself.

In addition, the standards for interstate bank acquisitions would be raised. BHCs, which currently may make interstate bank acquisitions if they are adequately capitalized and adequately managed, would need to be well capitalized and well managed to make such acquisitions. The standards for the resulting bank following an interstate merger also would be raised from adequately capitalized and managed to well capitalized and managed.

Enhancement of Affiliate Transaction Requirements. The White Paper also recommended that holes in the existing set of federal restrictions on transactions between banks and their affiliates should be closed. To address these issues, the proposed legislation would make various enhancements to the affiliate transaction requirements under Section 23A of the Federal Reserve Act. First, the definition of “affiliate” applicable to pooled investment vehicles would be clarified such that any “investment fund” that is advised by the bank or one of its affiliates is an affiliate of the bank. In addition, the definition of “covered transaction” for purposes of Section 23A would be expanded to include credit exposure from securities lending and derivative transactions with affiliates. Another enhancement to the affiliate transaction requirements would be to specify that covered transactions between a bank and its affiliates should be collateralized “at all times.” In addition, certain exemptions for transactions involving financial subsidiaries would be eliminated, including by making transactions between a bank and its financial subsidiary subject to the aggregate transaction limits of Section 23A. Finally, the FRB would be required to obtain the concurrence of the FDIC (and also the National Bank Supervisor if the bank is a national bank) to exempt transactions from affiliate transaction requirements.

Tightening of Lending Limits. The proposed legislation includes provisions that would apply lending limits for banks and insider lending limits to derivatives and certain other transactions. These specific proposals were not outlined the White Paper, but are consistent with its recommendation of subjecting OTC derivatives markets to comprehensive regulation.

First, the proposed legislation would tighten lending limits for banks by treating credit exposures on over-the-counter derivatives, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions as extensions of credit for purposes of national bank lending limits. Rules regarding such credit exposures would need to be adopted by the National Bank Supervisor within 180 days after the statute’s enactment. In addition, all insured state banks would be made subject to national bank lending limits, including the newly tightened limits.

The proposed legislation also would tighten restrictions on transactions with insiders. First, insider-lending limits would be applied to over-the-counter derivatives, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions. In addition, an insured depository institution would be prohibited from entering into asset purchase or sales transactions with its executive officers, directors, or principal shareholders or a related interest unless the transaction is on market terms and, if the transaction represents more than 10 percent of the bank’s capital stock and surplus, the transaction has been approved in advance by a majority of the disinterested members of the bank’s board of directors.

Other Provisions. The proposed legislation would address the White Paper's recommendation to limit opportunities for regulatory arbitrage opportunities by restricting the ability of troubled banks to convert their charters from national to state or vice-versa. A bank would not be able to convert its charter if the bank is subject to a cease and desist order, memorandum of understanding, or other enforcement action by an applicable federal or state regulator.

In addition, the authority of banks to open de novo branches in new states would be enhanced by amendments to interstate banking provisions that would permit national and state banks to establish branches if the law of the state where the branch is located or is to be located would permit establishment of the branch if the bank were a bank chartered in that state. Implementing a change recommended in the White Paper, these amendments would remove the remaining restrictions on interstate branching by national and state banks, giving them the authority that is currently enjoyed by federal thrifts.

The proposed legislation also would require the FRB, the FDIC, and the National Bank Supervisor to jointly adopt rules to coordinate the assessment of fees for the examination of banks, BHCs, and Tier 1 financial holding companies subject to their jurisdiction. This proposal was not reflected in the White Paper, but is consistent with the objectives of limiting regulatory arbitrage opportunities since it would minimize differences in examination assessments.

Proposed Legislation Creating Office of National Insurance

As part of its financial regulatory reform program, the Obama Administration, through the Treasury, submitted [proposed legislation](#) to Congress that is designed to implement the recommendations regarding the creation of an Office of National Insurance (the "ONI") within the Treasury that were made in the Treasury's June 2009 White Paper on financial regulatory reform (as discussed in the [June 23, 2009 Alert](#)). The proposed legislation contains the following principal elements: (a) it creates the ONI in the Treasury; (b) it gives the ONI authority to monitor the insurance industry and recommend to the Board of Governors of the Federal Reserve System that "an insurer, including its affiliates" be subject to regulation as a Tier 1 financial holding company; (c) it gives the Secretary of the Treasury authority to negotiate and enter into bilateral or multi-lateral agreements on behalf of the United States with foreign governments, authorities, and regulatory bodies regarding "prudential measures applicable to the business of insurance or reinsurance" ("International Insurance Agreements on Prudential Measures"); and (d) it gives the ONI the power to determine, following notice and an opportunity to comment, that state insurance measures are preempted by International Insurance Agreements on Prudential Measures.

To support the ONI's various functions, the proposed legislation gives it the power to require an insurer, or an affiliate of an insurer, to provide it with data or information, subject to an exception for small insurers. The ONI would be required to coordinate with relevant state insurance regulators or other relevant federal or state regulatory agencies to determine if information the ONI seeks may be available from those parties. The savings provisions of the proposed legislation provide that it shall not preempt any state insurance measure that governs any insurer's rates, premiums, underwriting or sales practices, or state coverage requirements for insurance or the application of state anti-trust laws to the business of insurance.

The proposed legislation significantly fleshes out the White Paper's recommendations by specifying (a) the information gathering mechanism that would enable the ONI to monitor the insurance industry and individual insurers and their affiliates, and (b) the ONI's and the Secretary of the Treasury's authority and respective roles in coordinating U.S. and non-U.S. prudential standards for the insurance industry. The proposed legislation does not, however, address the White Paper's call for increased national uniformity of insurance regulation (except to the extent such uniformity may result from the ONI's exercise of its preemption powers in relation to International Insurance Agreements on Prudential Measures).

Proposed Legislation for Public Company Executive Compensation Reform

As part of its financial regulatory reform program, the Obama Administration, through the Treasury, submitted to Congress [proposed executive compensation reform legislation](#) designed to implement recommendations made in the Treasury's June 2009 White Paper on financial regulatory reform (as discussed in the [June 23, 2009 Alert](#)). The proposed legislation would grant shareholders of public companies a non-binding vote to approve compensation (so-called "say-on-pay") and would enhance the independence standards applicable to the compensation committees of public company boards.

Say-on-Pay. The proposed legislation generally would require a public company's annual proxy statement relating to any shareholder meeting scheduled to occur on or after December 15, 2009 to include a separate non-binding vote to approve the compensation of executives as disclosed in the proxy statement pursuant to the SEC's compensation disclosure rules. The proposed legislation also would require a public company's proxy statement for a corporate transaction (such as a merger, acquisition, consolidation or sale of assets) relating to a shareholder meeting scheduled to occur on or after December 15, 2009 to include a separate non-binding vote to approve certain "golden parachute" compensation arrangements. The "golden parachute" compensation arrangements covered by the vote would include any agreements or understandings the target or acquiring company has with the company's executive officers, relating to compensation based on, or otherwise related to, the corporate transaction.

The proposed legislation specifies that any such "say-on-pay" vote by shareholders would not be binding on the company or its board of directors, would not impose any additional fiduciary duties on the company's board of directors, and would not prevent shareholders from making additional executive compensation-related proposals for inclusion in the company's proxy statement. The proposed legislation would direct the SEC to issue rules implementing say-on-pay within one year of enactment.

Compensation Committee Independence. The proposed legislation would establish independence standards for the compensation committees of public company boards of directors. Specifically, the proposed legislation would require the following:

- Each member of the compensation committee would be required to satisfy new independence standards. Under these standards, committee members would be prohibited from accepting any consulting, advisory or other compensatory fee from the company (other than in his or her capacity as a director or committee member), or otherwise be an affiliated person of the company or any of its subsidiaries.

- Any compensation consultant, legal counsel or other adviser to the compensation committee would be required to satisfy independence standards to be established by the SEC.
- The compensation committee would have the authority, in its discretion, to engage its own compensation consultants, legal counsel and other advisers. Companies would be required to provide appropriate funding, as determined by the compensation committee, to pay for such consultants, counsel and advisers.
- Companies would be required to disclose in their annual proxy statements whether the compensation committee retained a compensation consultant meeting the independence standards, and if not, an explanation for the committee's determination.

Under the proposed legislation, the SEC would be required, not later than 270 days after enactment, to direct national securities exchanges and national securities associations to prohibit listing securities of any companies that fail to comply with the new compensation committee independence rules.

Appeals Court Sends Fixed Index Annuity Rule Back to the SEC

The U.S. Court of Appeals for the District of Columbia Circuit (the "Court") ruled that while the SEC's statutory basis for new Rule 151A under the Securities Act of 1933 (the "1933 Act") addressing fixed index annuities was reasonable, the SEC failed to properly consider the effect of the rule upon efficiency, competition and capital formation. On that basis, the Court remanded the matter to the SEC to address the shortcomings in its rulemaking.

Statutory Basis. The Court found that in adopting Rule 151A the SEC had permissibly interpreted the term "annuity contract" under the exclusion of Section 3(a)(8) of the Securities Act. Rule 151A under the Securities Act provides that an annuity issued by an insurance company is not an "annuity contract" or an "optional annuity contract" excluded from the 1933 Act's registration requirements under Section 3(a)(8) of the 1933 Act if the annuity exhibits certain characteristics (as discussed in more detail in the [January 13, 2009 Alert](#)). The Court held that Section 3(a)(8) is ambiguous, or at the very least silent, on whether the term "annuity contract" encompasses all forms of annuity contracts, including the fixed index annuity ("FIA") contracts Rule 151A targets, and therefore, Rule 151A would be upheld if it were determined to be a reasonable interpretation of the statute. The Court concluded that the SEC had "adopted an interpretation that is based in reason." The Court found that "Rule 151A appears to be the SEC's means of ensuring greater protection for consumers exposed to greater risks when insurers are exposed to less risk than normal." The Court found that the SEC need not include a marketing test in its rule. It noted, among other factors, that "[w]here, as here, the essential characteristic of the product bestows upon that product obvious securities-like qualities, it is reasonable to assume that any marketing of the product would correspondingly be securities-related."

Analysis of Effect on Efficiency, Competition and Capital Formation. The Court found that the analysis regarding the effect of Rule 151A on efficiency, competition and capital formation conducted by the SEC as part of the rulemaking process was deficient. The Administrative Procedures Act requires that, for every rulemaking in which the SEC is required to consider or determine whether an action is necessary or appropriate in the public interest, the SEC must also consider, in addition to the protection of investors, whether the

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action will promote efficiency, competition and capital formation. Although the adopting release for Rule 151A included such an analysis, on appeal the SEC argued that no such analysis was required. The Court ruled that having undertaken the analysis, the SEC must defend it and could not argue that the analysis was not required. In reviewing the analysis, the Court found that the SEC did not disclose “a reasoned basis for its conclusion that Rule 151A would increase competition.” The Court found that the SEC “cannot justify the adoption of a particular rule based solely on the assertion that the existence of a rule provides greater clarity to an area that remained unclear in the absence of any rule.” The Court also found that the analysis failed because the SEC did not make any findings on the existing level of competition in the marketplace under the state law regime. The Court further determined that the SEC’s analysis was incomplete because the SEC failed to determine, whether, under the existing regime, sufficient protections existed to enable investors to make informed investment decisions and sellers to make suitable recommendations to investors.

In remanding the matter to the SEC, the Court stated that the SEC must either complete an analysis sufficient to justify its obligations under the analysis of efficiency, competition and capital formation, or explain why that analysis is not required for this rulemaking.

OTHER ITEM OF NOTE

Federal Banking Agencies Issue Final Revisions to Flood Insurance Q&As

The federal banking agencies issued final revisions to the Interagency Questions and Answers Regarding Flood Insurance. The agencies are also soliciting comments on proposed revisions to the Q&As. The final and proposed revisions cover a wide-range of flood insurance issues, including: (1) when flood insurance is required; (2) the appropriate amount of flood insurance; (3) exemptions; (4) flood insurance requirements for nonresidential buildings and condominiums; (5) flood insurance requirements for home equity loans, home equity lines of credit and construction loans; (6) escrow requirements; (7) force placement; (8) private insurance policies; and (9) flood zone discrepancies. The revised Q&As are effective September 21, 2009 and comments on the proposals must be received by the same date. [Click here](#) for the final and proposed Q&As.