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DEVELOPMENTS OF NOTE

Federal District Court Issues Decision in Favor of Defendant Mutual Fund Adviser and Affiliated Distributor on Excessive Fee Claim

In a decision issued on December 28, 2009, the U.S. District Court for the Central District of California (the "Court"), determined that the plaintiff investors in various mutual funds had failed to satisfy their burden of proof in their excessive fee suit brought under Section 36(b) of the Investment Company Act of 1940, as amended (the "1940 Act"), against the funds' investment adviser and affiliated distributor regarding various investment management, Rule 12b-1 and other servicing fees paid to the defendants and their affiliates. Section 36(b) provides that an investment adviser has a fiduciary duty to shareholders with respect to the receipt of compensation for services by the adviser and its affiliates. The decision generally tracked the statement of intended decision (the "Statement") issued by the Court in September, which explained the Court's factual findings and legal conclusions with respect to the case, and directed the defendants' to submit proposed findings of fact and conclusions of law before the Court rendered its final decision. For a detailed discussion of the Statement and the Court's factual findings contained therein, see the [September 29, 2009 Alert](#).

In its final decision, while acknowledging that the Seventh and Eighth Circuits have recently adopted alternative tests for determining whether a violation of Section 36(b) has occurred, the Court chose to analyze the allegations and evidence presented at trial using the multi-factor analysis for suits under Section 36(b) established by the U.S. Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982) ("*Gartenberg*"). (For more information on the 2008 Section 36(b) decision rejecting *Gartenberg* that was handed down by the Seventh Circuit and is currently

under review by the Supreme Court, see the [March 10, 2009 Alert](#). For a discussion of the 2009 Eighth Circuit decision, which articulated yet another Section 36(b) standard, see the [April 14, 2009 Alert](#).) The Court observed that *Gartenberg* establishes a very high hurdle for the plaintiff shareholders to prove a breach of fiduciary duty under Section 36(b). In accordance with *Gartenberg*, the Court analyzed the nature and quality of the services provided to the funds; the defendants' profitability with respect to the funds; whether and to what extent the defendants realized economies of scale as fund assets increased; the comparability of the funds' fees to those of other similar funds; any fall-out benefits accruing to the defendants from their relationship with the funds; and the conduct and expertise of, and level of information possessed by, the funds' directors in approving the fees. The Court's opinion includes extensive findings of fact, which, among other things, set forth detailed schedules of the 12b-1 fees, advisory fees and transfer agency/administrative fees paid by the subject mutual funds, and a description of the contract approval process.

Independence and Conscientiousness of the Independent Directors. The Court rejected the plaintiffs' arguments that the funds' independent directors were not truly independent, did not perform their duties with sufficient care and lacked sufficient information regarding profit margins on administrative services fees and 12b-1 fees paid to the funds' investment adviser and distributor, respectively. The Court concluded that the defendants presented substantial evidence at trial to support their claim that the independent directors' independence and the contract approval process satisfied the standard set forth in *Gartenberg*; however, the Court rejected a proposed finding of fact that "the independent directors were well-informed on all material issues, and exercised their business judgment in a manner that they reasonably determined was in the best interests of the fund shareholders." Although the record contained "sufficient evidence to establish that the directors met their obligations under the *Gartenberg* standard," in the Court's view, the independent directors did not diligently inquire into some issues of importance, and failed to recognize the consequences of some information presented to them. In this regard, the Court questioned (a) the independent directors' acceptance without further inquiry of statements that the compensation paid to the defendant adviser and distributor's employees was necessary to meet competition in the marketplace, and (b) the independent directors' consideration of the fact that the increase in the adviser's assets under management during the period in question was largely due to the appreciation of existing assets, not additional amounts invested as result of distribution efforts paid for with the funds' 12b-1 fees. The Court also believed that the independent directors did not receive sufficient information regarding the profit margins for administrative services provided to the funds. The Court, nevertheless, determined that its questions regarding the conscientiousness of the funds' independent directors were not sufficient to rebut "the substantial evidence that the overall conduct of the directors met the *Gartenberg* standard," and concluded based on the entirety of the record that "the Unaffiliated Directors carefully and diligently exercised their responsibility in approving the fees at issue."

Nature and Quality of Services. The plaintiffs claimed that (a) the defendants violated Section 36(b) because they charged the funds Rule 12b-1 fees designed to promote growth in fund assets at a time when increasing fund assets were creating problems for fund management and harming fund performance and (b) the adviser breached Section 36(b) because it (i) unreasonably failed to adjust its advisory fee schedule downward sufficiently in response to growth in fund assets and used a portion of its advisory fees to make undisclosed revenue sharing payments to broker-dealers and (ii) essentially admitted it had been charging excessive fees for administrative services provided to the funds when the

adviser instituted a cap on those fees during the period covered by the suit . Ultimately, the Court concluded that arguments regarding the propriety of the use of fees and the effect of dramatic asset growth in each area cited by plaintiffs – 12b-1 fees, advisory fees and transfer agency/administrative fees – could not serve as a basis for liability under Section 36(b) because the arguments and evidence presented at trial failed to implicate the nature and quality of the services provided by the defendants.

Profitability of the Funds. The Court concluded that the defendants’ profitability during the relevant time period did not weigh in favor of finding a violation of Section 36(b) since defendants’ profit margins were within the range permitted by other courts under Section 36(b).

Economies of Scale. The Court found that the plaintiffs could not successfully argue that the defendants had not equitably shared economies of scale with the funds because the plaintiffs failed to prove that economies of scale existed for the funds. In this regard, the Court noted that the only evidence offered by the plaintiffs to prove that economies of scale existed was the testimony of plaintiffs’ own expert witness which was flawed and insufficient to establish the existence of economies of scale. Specifically, the Court noted that the plaintiffs’ expert failed to adequately analyze whether the per unit operating cost of the funds decreased as the size of the funds increased.

Comparative Fee Structures. The Court observed that, although relevant, a comparison of the expense ratios of the funds at issue to those of other funds was “of minimal probative value” in the context of a Section 36(b) inquiry due to the difficulty of a fund changing advisors, citing *Gartenberg*. The Court, nonetheless, went on to conclude that the evidence showing that the funds’ fee structure was lower than the industry average supports a finding that the defendants’ fees were not disproportionate to the services rendered.

Fall-Out Benefits. The Court found that there was no evidence establishing any fall-out benefits to the defendants from their relationships with the funds, whose management and servicing constitute the defendants’ sole enterprise. The Court also observed that since all revenue received by the defendants would be reflected in the financial statements provided to the independent directors in connection with contract approvals, “any potential fall-out benefits would have been considered by the Board as part of their review of those financial statements.”

Banking Agencies Remind Depository Institutions of Supervisory Expectations with Respect to Interest Rate Risk Management

The federal banking agencies and the Federal Financial Institutions Examination Council’s State Liaison Committee (the “Agencies”) issued an advisory (the “Advisory”) which reminds federally insured depository institutions (“institutions”) of supervisory expectations regarding managing interest rate risk (“IRR”). The Agencies issued the Advisory in part because the current economic environment has exacted pressure on institutions’ earnings and the value of institutions’ securities portfolios. The Advisory notes that while each of the Agencies has issued distinct guidance with regard to IRR management (such guidance is listed in the Advisory), supervisory expectations for IRR management are broadly consistent for all institutions. The Advisory focuses on the importance, with respect to IRR management, of corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal controls related to IRR exposures. The Advisory also recognizes that some IRR is inherent to the business of banking.

With respect to corporate governance, the Advisory identifies the board of directors of an institution as having the ultimate responsibility for managing IRR. The board of directors or a designated committee should oversee and annually review IRR management strategies, policies, procedures, and limits. Senior management of an institution should implement board-approved strategies, policies, and procedures. Additionally, management is responsible for managing IRR on a day to day basis, including staying within board-approved tolerances and maintaining comprehensive systems for measuring IRR and detailed IRR reporting processes. Finally, management and the board of directors are responsible for ensuring that the board of directors has access to both aggregate and sufficiently detailed information regarding IRR.

The Advisory states that institutions are expected to have IRR policies and procedures that integrate new strategies, products and businesses. Such policies and procedures should govern all aspects of an institution's IRR management process. IRR tolerances articulated in such policies should be explicit and address the short-term and long-term perspective, and also address basis risk, yield curve risk, and the institution's positions with explicit or embedded options.

The Advisory further notes that institutions are expected to have robust IRR measurement and monitoring processes and systems that are commensurate with the size and complexity of the institution. Institutions may rely on third-party IRR models, so long as they thoroughly understand them. Institutions may use a variety of techniques to measure IRR exposure. The Agencies believe that while simple maturity gap analysis may be sufficient for some institutions, many institutions choose to use simulation modeling, which is now accessible to smaller and less complex institutions. Institutions are encouraged to use the full complement of analytical capabilities of IRR simulation models. IRR exposures are best projected over a two-year period; however, the Agencies suggest that longer time horizons, such as five to seven year time horizons, should also be analyzed. Static or dynamic simulation models may be used. The Agencies suggest that simulation models alone may be insufficient to evaluate IRR and suggest that economic value models also be used.

The Advisory further states that measurement and monitoring should also include stress testing, which should include both scenario and sensitivity analysis. Scenario analysis should include, as applicable, analysis of instantaneous and prolonged rate shocks, basis risk, and yield curve risk. Sensitivity analysis should also be conducted to determine which assumptions have the most influence on IRR model outputs. Finally, prudent IRR measurement and monitoring depends on sound and properly updated assumptions.

The Advisory also makes clear that risk mitigating steps are an important component of IRR management. In particular, management should be able to easily identify when IRR limits are approached or exceeded and should take appropriate action. The Agencies suggest that the most common way of addressing excessive IRR is through balance sheet adjustment. However, hedging and other derivative-based strategies are also available. Institutions that wish to use derivative strategies must have adequate knowledge of, and expertise in, using derivative instruments.

Finally, the Advisory states that IRR models must be independently validated. Validation is best performed through an independent review of the conceptual and logical soundness of the IRR model. The results of such review should be available to relevant Agencies. Smaller institutions that do not have the resources to staff an independent review function

may rely on internal parties for such a review if such internal party is sufficiently removed from the IRR management process. Alternatively, an external auditor may be used. Institutions that use vendor-supplied IRR models are not required to test the mechanics and mathematics of such models, so long as the vendor supplies documentation for the program. However, larger and more complex institutions may need to be more proactive in validating vendor-provided models, including the use of “benchmark” models to test the performance of vendor-provided IRR models.

SEC Division of Corporation Finance Makes Available Slides of Staff Presentation Concerning Frequent Areas of Comment on Filings for Community Banks

The SEC made publicly available a series of [slides](#) (the “Slides”) that were used in a presentation by Stephanie L. Hunsaker, Associate Chief Accountant of the SEC’s Division of Corporation of Finance (the “Division”) concerning issues that Division staff (the “Staff”) frequently encounter when reviewing SEC filings made on behalf of community banks. In addition to covering areas of Staff comment, the Slides provide suggestions for enhanced disclosure.

The slides address the following specific areas of Staff frequent comment:

- (1) Allowance for Loan Losses
- (2) Troubled Debt Restructurings
- (3) Other Real Estate Owned
- (4) Purchased Loans
- (5) U.S. Treasury Mortgage Modification Programs
- (6) Securities Impairment
- (7) Goodwill Impairment
- (8) Deferred Tax Asset Valuation
- (9) Fair Value Disclosures
- (10) TARP Transactions
- (11) Regulatory Actions or Recommendations
- (12) FDIC-Assisted Transactions

Below, as examples, are overviews of Ms. Hunsaker’s suggestions for enhanced disclosure in three of these areas.

Allowance for Loan Losses. With respect to a bank’s allowance for loan losses (“Allowance”), Ms. Hunsaker’s Slides provide suggestions for enhanced disclosure concerning, among other things, (a) allowance methodology; (b) increased levels of charge-offs; (c) concentrations of credit risk; (d) levels of interest reserves for real estate construction loans; and (e) loans measured for impairment based on collateral value.

Securities Impairment. Regarding securities impairment, the Slides suggest areas of potential enhanced disclosure concerning trust preferred securities, mortgage-backed securities, equity securities and investments in Federal Home Loan Bank stock. The Slides also discuss enhanced disclosure for banks’ holdings of all types of securities.

Regulatory Actions. Ms. Hunsaker's Slides state that when a bank is subject to a formal bank regulatory agreement, the Staff would expect disclosure that:

- (1) summarizes all provisions;
- (2) describes steps taken or to be taken to comply with each provision;
- (3) describes current compliance with each provision;
- (4) describes any material impact on future operations; and
- (5) describes the potential consequences if there is a failure to comply.

Where the bank regulatory agreement is informal, *e.g.*, a memorandum of understanding, the Staff recognizes that the agreement is "not required to be disclosed if prohibited by banking regulations," but the Slides state that a bank "must disclose actions taken or to be taken if they have a material impact on future operations."

Ms. Hunsaker notes that the Slides, although reflecting Staff comments on filings for community banks, may also be useful to other financial institutions.

OCC Issues Interpretive Letter Authorizing National Bank to Hold Auction Rate Securities, Subject to Certain Conditions

The OCC issued an interpretive letter ("Letter # 1124") addressing the issue of whether a national bank (the "Bank") may directly hold auction rate securities (the "ARS"). The OCC stated that, as a general matter, the Bank could directly hold the ARS, conditioned upon the Bank's compliance with certain specified conditions.

Specifically, the OCC concluded in Letter # 1124 that the Bank, pursuant to 12 C.F.R., Part 1, may acquire the ARS as investment securities. The OCC mandated, however, that the Bank's acquisition of the ARS be subject to three enforceable conditions. First, prior to the acquisition of the ARS, the Bank must enter into an operating agreement with the OCC, which shall require the Bank to enter into an indemnification/repurchase agreement with the Bank's holding company (the "Holding Company") within 30 days of the Bank's acquisition of the ARS. Second, under the indemnification/repurchase agreement, the Holding Company must agree to cover certain losses and expenses that the Bank (including any of the Bank's subsidiaries) may incur as a result of its acquisition of the ARS, and the Holding Company must also agree to repurchase all of the ARS from the Bank, no later than a date specified by the OCC. Finally, the OCC required that the Bank's Board of Directors must give assurances to the OCC that the operating agreement is fully adopted, timely implemented, and adhered to thereafter. The OCC also stated that the Bank must seek prior guidance from the OCC before terminating, modifying, or amending either its operating agreement with the OCC or its indemnification/repurchase agreement with the Holding Company.

SEC Staff Grants Extension of No-Action Relief That Permits Broker-Dealers to Rely on Registered Advisers to Perform AML Customer Identification Programs

The staff of the SEC's Division of Trading and Markets issued a [no-action letter](#) extending no-action relief originally granted in 2004 that allows a registered broker-dealer to rely on a registered investment adviser to perform some or all of the broker-dealer's anti-money laundering ("AML") customer identification program ("CIP") with respect to shared customers. The AML rules applicable to broker-dealers allow reliance on a third party to

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conduct elements of the broker-dealer's CIP only if certain conditions are met, one of which is that the third party must be subject to a rule requiring it to maintain an AML program (an "AML Rule"). Registered advisers cannot meet this condition because they are not subject to an AML rule. One was proposed for them in 2002 but withdrawn in 2008 (as discussed in a [December 15, 2008 Goodwin Procter Client Alert](#)).

The relief is subject to the following conditions: (1) the broker-dealer's reliance on the investment adviser is reasonable under the circumstances; (2) the investment adviser is registered with the SEC; (3) the investment adviser enters into a contract with the broker-dealer requiring the adviser to certify annually to the broker-dealer that the adviser has implemented its own AML program that is consistent with Bank Secrecy Act requirements; and (4) the adviser (or its agent) performs the specified requirements of the broker-dealer's CIP. The relief is automatically withdrawn on January 10, 2011 and is subject to reconsideration if an AML rule for registered advisers is proposed before that date.

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