

FINANCIAL SERVICES ALERT

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DEVELOPMENTS OF NOTE

Massachusetts Supreme Judicial Court Issues Decision Limiting Banks' Liability in Check Collection Process

The Supreme Judicial Court of Massachusetts ("SJC" or the "Court") issued a decision in favor of Fleet National Bank (now Bank of America) (the "Bank") in the case of *Gossels v. Fleet National Bank*, SJC-101186. The case called into question core principles governing the vast check collection system in the United States, including the duty of care owed by collecting banks to customers who submit foreign checks for collection, the disclosures that collecting banks are required to make, and the appropriate allocation of risk for currency fluctuations between customers and collecting banks. The case had been tried before the Superior Court and argued on appeal at the Massachusetts Court of Appeals, with differing results.

Goodwin Procter LLP representing the Massachusetts Banker's Association (the "Association") filed an *amicus curiae* brief in the case. Litigation partners Brenda Sharton and Dahlia Fetouh worked with Financial Services partner Lynne Barr to analyze the key issues and draft a comprehensive brief that succinctly highlighted for the Court the important policy concerns raised by the case. Goodwin's brief outlined how the Appeals

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Court decision ran contrary to the Uniform Commercial Code (“UCC”) and over 175 years of settled banking law and further argued that, if left standing, the decision would threaten the operation of the check collection system to the detriment of banks that do business in Massachusetts and their customers.

The SJC heard oral argument on November 3, 2008. In the SJC’s opinion, the Court specifically acknowledged the Association’s *amicus* brief in one of its lead footnotes and directly adopted many of the arguments advanced therein. The Court led its written decision by describing one of the primary themes stressed in Goodwin’s brief: the importance of the national, uniform system of check collection adopted by the UCC and the need to enforce that uniform system lest “banks . . . face a motley patchwork of liability standards from State to State.”

The Court then re-affirmed two critical principles, advanced by the Association and the Bank, governing the liability of collecting banks in the check collection system that the previous decisions in this case had called into question: (1) the bank customer remains the owner of the check through the collection process and bears the risk of collection, including the risk of currency fluctuation, and (2) the collecting bank is only held to a standard of ordinary care in making the collection. Because these bedrock principles had been thrown into question following the earlier decisions in this case, the SJC’s decision will provide useful guidance and support for banks going forward.

The Court then examined each of the plaintiff’s individual claims against the Bank and the following is a summary of some of the key holdings. Most importantly, the Court provided guidance and clarity on the disclosure obligations of collection banks. Specifically, the Court concluded that the lower courts had ruled incorrectly when they imposed disclosure obligations on the Bank that are not required by the UCC.

The Court solidified the critical standard of care set by the UCC for collecting banks. Under the lower court decisions, collecting banks were threatened with being required to meet heightened standards of care for every check collected. The Court stated clearly that the “UCC only requires that collecting banks use ordinary care as they seek to collect settlements on instruments.” Adopting an argument advanced by the Association and the Bank, the Court stated that elevating a bank’s internal manuals to a set of affirmative disclosure requirements on par with the disclosure requirements of the UCC “would vitiate the goal of mak[ing] uniform the law amount the various jurisdictions.”

In another ruling important for banks in the Commonwealth, the Court also made clear that banks are not liable for conversion (the wrongful exercise of control over specific personal property of another) when they fail to pay funds that they owe to a customer, and that bank accounts cannot be the subject of a claim for conversion.

Goodwin’s brief in this case highlights the collaborative relationship between Goodwin’s Litigation Department and Financial Services Group on behalf of our financial services clients. If you have questions about the decision and its effect on the check collection system in Massachusetts, please contact [Brenda Sharton](#) or [Lynne Barr](#).

US Senator Introduces Bill to Stop Perceived Abuses of Tax Havens and Off-Shore Entities

US Senator Carl Levin (D-Mich) introduced the Stop Tax Haven Abuse Act (the “Act”) in the Senate. The Act is intended to curb certain perceived abusive uses of offshore entities to avoid US federal income taxes. If enacted, the Act will likely have significant tax ramifications for certain investment funds with primarily US-based management.

In particular, a provision of the Act would treat certain foreign corporations (including offshore investment funds currently classified as foreign corporations for US federal income tax purposes) managed and controlled in the US as domestic corporations for US federal income tax purposes. The Act specifically provides that a typical investment fund which is organized as a foreign corporation would be considered managed and controlled primarily in the US if decisions about how to invest its assets are made in the US. This provision is limited to offshore corporations whose stock is “regularly traded on an established securities market,” or which have at least \$50,000,000 of aggregate gross assets at any time during the current or preceding taxable year. Thus, a foreign corporation to which the provision applied would be subject to full US federal income tax.

The provision is proposed to apply to taxable years beginning on or after the date which is two years after the date of the enactment of the Act..

Basel Committee Announces Increased Capital Initiative

The Basel Committee on Banking Supervision (the “Basel Committee”) announced an initiative to increase the level of capital held by banks. The Basel Committee said this goal will be achieved “by a combination of measures such as introducing standards to promote the build up of capital buffers that can be drawn down in periods of stress, strengthening the quality of bank capital, improving the risk coverage of the capital framework and introducing a non-risk based supplementary measure.” The Basel Committee also will review the minimum level of capital required next year to establish a total level and quality of capital that is higher than the current Basel II framework.

OCC Issues Letter Concerning Treatment of TLGP Debt under OCC Investment Securities Regulations

The OCC has issued Interpretive Letter No. 1109 (“Letter 1109”) discussing the interaction between the OCC’s investment securities regulations at 12 CFR Part 1 and the Temporary Liquidity Guarantee Program (“TLGP”) of the FDIC. In Letter 1109, the OCC was asked whether the guarantee of a qualifying debt security under the TLGP would transform the security into a Type I security for purposes of the OCC’s investment securities regulations.

As adopted on November 21, 2008, the TLGP program covers all newly issued senior unsecured debt issued by eligible entities after Oct. 13, 2008, and before July 1, 2009. The new debt issued before July 2009 will be protected until the earlier of maturity or June 30, 2012, leading to the possibility that some new debt will be FDIC guaranteed for its entire tenor and other eligible debt will be protected only for a portion of its tenor.

The OCC concluded that in cases where the security’s tenor is no longer than the term of the guarantee, the security will qualify as a Type I security. In cases where the security’s

tenor exceeds the term of the FDIC guarantee, the security will not qualify as a Type I security.

The OCC cautioned that although a national bank's purchase and holding of Type I securities is not generally limited to a specified percentage of the bank's capital and surplus, as a matter of safety and soundness, banks should avoid acquiring excessive concentrations in TLGP qualifying debt. The OCC noted that the federal banking agencies in their risk-based capital rules have decided to apply a 20% risk weight to debt that is guaranteed by the FDIC, rather than a zero risk weight applicable to US government securities.

Subsequent to the issuance of Letter 1109, on March 17, 2009, the Board of Directors of the FDIC voted to extend the debt guarantee portion of the TLGP from June 30, 2009 through October 31, 2009. The guarantee on debt issued before April 1, 2009, will expire no later than June 30, 2012. The guarantee on debt issued on or after April 1, 2009, will expire no later than December 31, 2012.

Second Circuit Affirms Dismissal of Securities Fraud Claims against Brokers over Shelf-Space Payments Relating to Mutual Fund Sales

The US Court of Appeals for the Second Circuit (the "Court") affirmed the dismissal of a claim of securities fraud under Section 10(b) and Section 20(a) of the Securities Exchange Act of 1934 against affiliated broker-dealers and their parent (collectively, the "Broker-Dealer") by shareholders of certain mutual funds sold to them by the Broker-Dealer. The plaintiffs alleged that the Broker-Dealers failed to properly disclose that they were receiving payments and other financial incentives from the mutual funds' distributors and/or investment advisers in return for promoting the sale of the mutual funds (the "Shelf-Space Arrangements"). The dismissal by the US District Court for the Eastern District of New York (the "District Court") was based on a finding that the complaint's description of the Broker-Dealers' activities was too generalized to meet the heightened standards for pleading securities fraud under the Private Securities Litigation Reform Act, and to the extent the plaintiffs identified specific sums that the Broker-Dealers would gain from each mutual fund transaction with the plaintiffs, the amounts were too small to state a claim upon which relief could be granted.

The Court affirmed the dismissal on grounds other than those relied on by the District Court. The Court observed that in their complaint the plaintiffs had incorporated by reference website disclosures made by the Broker-Dealers that detailed the allegedly undisclosed Shelf-Space Arrangements and that the mutual funds' prospectuses and statements of additional information also disclosed the Shelf-Space Arrangements. Because these disclosures placed the plaintiffs on notice of the conflict of interest that was the basis of the complaint more than two years prior to the filing of the complaint, the Court found that the plaintiffs were barred by the statute of limitations. The Court's ruling was by summary order, which does not have precedential affect, but may be cited under conditions specified in the Court's rules.

SEC Staff Provides No-Action Relief for Purchasers of Liquidity Protected Preferred Shares from 1940 Act Restrictions on Transactions with Affiliates

The staff of the SEC's Division of Investment Management (the "Staff") provided no-action relief from certain provisions of the Investment Company Act of 1940, as amended (the

“1940 Act”), that could apply to a registered fund and certain of its affiliates (the “Affiliated Person Restrictions”) to the extent such provisions would be triggered when liquidity providers purchase liquidity protected preferred shares (“LPP”) issued by closed-end investment companies (“Funds”). As more fully described in the [July 1, 2008 Alert](#), LPP are a new type of preferred stock proposed to be issued by Funds to replace existing auction rate preferred stock. Similar to existing auction rate securities, LPP would have a dividend that is reset in a weekly remarketing through an auction process designed to match buyers and sellers. LPP would also have a liquidity protection feature under which an LPP issuer would contractually engage a third party liquidity provider that would unconditionally fulfill sell orders that did not receive matching purchase orders in a remarketing. The liquidity provider could be given rights to put any of the LPP that it had purchased to the issuing Fund’s sponsor or to the issuing Fund following a specified holding period (an “LPP Put”).

The current no-action relief, which supplements June 2008 no-action relief for LPP (discussed in the [July 1, 2008 Alert](#)), addresses the issue of whether a liquidity provider would trigger the Affiliated Person Restrictions by virtue of acquiring all or a large portion of a Fund’s LPP or by having an LPP Put. Section 2(a)(3)(A) of the 1940 Act defines an “affiliated person” as “any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person.” In addition, section 2(a)(3)(C) of the 1940 Act defines an “affiliated person” of another person as “any person directly or indirectly controlling, controlled by, or under common control with, such other person.” “Control” is defined elsewhere as “the power to exercise a controlling influence over the management or policies of a company.” Beneficial ownership of less than 25 percent of the voting securities of a company establishes a rebuttable presumption of non-control (although the Staff observed that “[n]o person may rely on the presumption that ownership of less than 25% of a company’s voting securities is not control if a control relationship exists under all the facts and circumstances”) that is rebuttable only on an SEC determination or judicial finding.

The no-action relief addressed the concern that affiliation may exist under Section 2(a)(3)(C) because (a) a liquidity provider holding all of a Fund’s LPP may be able to: (i) choose the two directors that Section 18(a)(2)(C) of the 1940 Act requires to be elected by holders of a Fund’s preferred stock; and (ii) defeat unilaterally a proposal that Section 18(a)(2)(D) of the 1940 Act requires receive the approval of a majority of a Fund’s outstanding preferred stock voting as a class (*i.e.*, a proposal relating to a plan of reorganization adversely affecting the preferred shareholders or any action requiring a shareholder vote under Section 13(a) of the 1940 Act, *e.g.*, changing to open-end status, changing policies on leverage or changing fundamental investment policies); or (b) a liquidity provider’s ability to exercise an LPP Put might appear to be a means of exerting control over a Fund. (The request for relief observed that affiliation solely based on ownership of voting securities is unlikely because even if a liquidity provider purchased the entirety of a Fund’s outstanding LPP, under the usual class structure, the liquidity provider would own far less than the 5% threshold imposed by Section 2(a)(3)(A).) The request for relief noted that the ability to elect two directors would not by itself ordinarily give a liquidity provider the power to exercise a controlling influence over the management or policies of a Fund because two directors would not typically represent a majority of the Fund’s directors or independent directors. The request for relief further noted that the ability of a liquidity provider to vote against, and effectively prevent, actions subject to Section 18(a)(2)(D) of the 1940 Act does not amount to the liquidity provider directing the Fund to take action, but instead represents merely the power to prevent the Fund from

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taking action the liquidity provider deems adverse to its interest as a preferred shareholder and liquidity provider. As to the LPP Put, the request for relief observed that the terms of an LPP Put provide for a holding period that would reduce or eliminate the power associated with the threat of large redemptions because the issuing Fund would have advance notice of the possibility of a large redemption. Without necessarily agreeing with the arguments or legal analysis in the request for relief, the Staff agreed not to recommend enforcement action to the SEC against a liquidity provider or Fund under the Affiliated Persons Restrictions that would be triggered solely by the liquidity provider's acquisition of LPP issued by a Fund under the terms of the LPP's liquidity protection feature and the existence of the LPP Put.

FDIC Issues Letter Cautioning against the Use of Volatile Funding Sources by Financial Institutions that are in a Weakened Condition

The FDIC issued a financial institution letter reminding directors and officers of FDIC-insured financial institutions that a strategy of aggressive asset growth or reliance on non-core liabilities (*e.g.*, high-cost brokered or internet deposits, secured borrowings, or deposits that are newly insured or guaranteed pursuant to temporary FDIC programs) will result in more extensive monitoring and examination by the FDIC, and may result in higher deposit insurance premiums.

FDIC-supervised institutions that are in a "weakened financial condition," those rated a "3," "4," or "5" by the FDIC, are expected to implement a plan to stabilize or reduce their risk exposure and to limit their growth. The FDIC noted that a continuation of "prudent lending practices" would not be considered as increasing a bank's risk profile. In addition, these plans may include a requirement to notify the appropriate Regional Director of the FDIC before undertaking asset growth or material changes in asset or liability composition.

OTHER ITEM OF NOTE

Goodwin Procter Launches Blog Covering Financial Crisis and Recovery

We are pleased to announce that Goodwin Procter has created a Blog that captures the wealth of our broad expertise on all aspects of the current financial crisis and the accompanying recovery efforts. Goodwin Procter is uniquely positioned to comment on and respond to issues in all industries affected by this crisis, including banking, hedge funds, investment management, capital markets and real estate.

Goodwin Procter provides regular updates and advisories that provide insight into the full range of business and legal issues brought on by rapidly shifting markets and sweeping regulatory changes in the financial services industry. The Blog is designed to serve as a topical digest of these publications to help you determine how these issues might affect your business and legal affairs and to help you navigate the myriad legislative, regulatory and enforcement challenges that may present themselves as a result of this crisis.

Please visit this new site at: <http://www.financialcrisisrecovery.com/>