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DEVELOPMENTS OF NOTE

Federal District Court Issues Statement of Intended Decision in Favor of Defendant Mutual Fund Adviser and Affiliated Distributor at Conclusion of Trial on Excessive Fee Claim

In a statement of intended decision issued on September 16, 2009 at the conclusion of a civil trial in the U.S. District Court for the Central District of California (the "Court"), the Court stated 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. (A statement of intended decision serves as an explanation of a trial court's factual findings and legal conclusions with respect to a case. Both the prevailing and losing party have the opportunity to submit findings of fact and conclusions of law before the final decision is rendered.)

Although the Court briefly acknowledged that other circuit courts had adopted alternative tests for determining whether a violation of Section 36(b) has occurred, the Court ultimately 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 F2d 923 (2d Cir. 1982) ("*Gartenberg*"). (For a discussion of the Eighth Circuit's decision establishing a

different Section 36(b) standard, see the [April 14, 2009 Alert](#). For more information on the Seventh Circuit's Section 36(b) standard, which will be reviewed by the Supreme Court, see the [March 10, 2009 Alert](#).) 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; and the conduct and expertise of, and level of information possessed by, the funds' directors in approving the fees.

Nature and Quality of Services. The plaintiffs claimed that 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. The Court rejected this claim, and other arguments made by the plaintiffs regarding Rule 12b-1 fees, because they did not address the nature and quality of the services provided in return for the fees charged. The Court similarly dismissed the plaintiffs' arguments that the adviser breached Section 36(b) because it 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. Ultimately, the Court stated 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 none of these arguments or any evidence presented at trial established that the nature and quality of the actual services provided was lacking.

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

Economies of Scale. The Court found that because the plaintiffs failed to prove that economies of scale existed for the funds, their arguments that the adviser did not equitably share economies of scale could not be unsuccessful. In this regard, the Court pointed to the testimony of plaintiffs' own expert witness who admitted that he was unable to determine whether economies of scale actually existed because of a lack of data.

Comparative Fee Structures. Notably, the Court rejected the defendants' arguments that the funds could not have experienced the growth they did if defendants were charging excessive fees since investors "vote with their feet" if assessed high fees. The Court pointed to the testimony of a witness for the defendants who had acknowledged that certain costs (*e.g.*, capital gains taxes) can prevent investors who pay excessive fees from switching funds because investors will not change funds if the cost of changing funds exceeds the amount of the excessive fees. Ultimately, the Court concluded that, although relevant, a comparison of the expense ratios of the funds at issue to those of their funds was "of minimal probative value" in the context of a Section 36(b) inquiry, citing *Gartenberg*.

Independence and Conscientiousness of the Independent Directors. Finally, Plaintiffs argued that the independent directors of the funds 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. Despite both being "troubled" by evidence presented at trial which raised legitimate concerns regarding the independence of

some of the independent directors and criticizing the independent directors' testimony that "tracked—at times nearly word for word—the testimony of the [adviser's] executives who took the stand," the Court ultimately concluded that the defendants presented substantial evidence at trial to support their claim that the independent directors were sufficiently independent for purposes of satisfying the standard set forth in *Gartenberg*. Such evidence included the existence of (i) committees composed entirely of independent directors that nominated independent directors and reviewed each board member's performance annually and (ii) independent legal counsel for the independent directors. The Court also cited the fact that (A) all board committees were made up entirely of independent directors; (B) all board chairpersons were independent directors; (C) each fund was comprised of a supermajority of independent directors; (D) each board meeting included an executive session where the independent directors have an opportunity to meet outside the presence of management and the affiliated directors; and (E) all the independent directors for each fund cluster sat on the contracts committee for that fund cluster. While, in the Court's view, the independent directors had not received enough information regarding the profit margins for administrative services provided to the funds, the Court noted that this evidence did not establish Section 36(b) liability without evidence of the nature of administrative services rendered by the fund adviser's affiliate and any third parties subcontracted to provide those services. *In re American Funds Fee Litigation*, CV 04-05593 GAF (RNBx) (C.D. Cal. Sept. 16, 2009).

Chairman of Senate Banking Subcommittee on Securities, Insurance and Investment Introduces Derivatives Regulation Legislation

Senator Jack Reed, Chairman of the Banking Subcommittee on Securities, Insurance and Investment, introduced the [Comprehensive Derivatives Regulation Act of 2009](#) (the "CDRA") on September 22, 2009. This third legislative proposal to regulate derivative transactions follows the Treasury's proposed Over-the-Counter Derivatives Markets Act of 2009 (the "Treasury Proposal") and the draft Derivatives Markets Transparency and Accountability Act of 2009, H.R. 977. (See the [August 27, 2009 Goodwin Procter Client Alert](#).) Congressmen Barney Frank, Chairman of the House Financial Services Committee, and Collin Peterson, Chairman of the House Agriculture Committee, also published last July a concept paper outlining their forthcoming legislation to address the regulation of derivatives. (See the [August 4, 2009 Alert](#).)

Senator Reed's bill goes farther in its scope than the Treasury Proposal in that it would apply to derivative products more broadly, subject to specific exclusions and exemptions. Similar to the Treasury Proposal, this new proposal would divide regulatory authority over products and market participants based on a distinction between security-based swaps and security derivatives and commodity-based swaps and commodity derivatives. In contrast to the Treasury Proposal, however, under the CDRA "security-based swaps" and "security derivatives" would be broadly defined. Security-based swaps and security derivatives would also (as under the Treasury Proposal) be securities and subject to regulation by the SEC, while the CFTC would have regulatory authority over commodity-based swaps and commodity derivatives. Accordingly, the SEC's authority with respect to derivatives would be significantly broader under the CDRA than under the Treasury Proposal.

The SEC and CFTC would have rulemaking authority with respect to any new derivative products introduced to the market under the new proposal. Before issuing any rule to exempt any product from regulation, the SEC and CFTC would be required to notify each other and the Federal Reserve Board (the "Board"). Proposed exemptions would be subject

to veto by each agency and the Board. Any dispute between the two agencies regarding the status of a derivative as a security-based derivative or a commodity-based derivative (including any exemption) would be appealable to the U.S. Court of Appeals for the District of Columbia.

On the other hand, Senator Reed's bill appears to not go as far as the Treasury Proposal in other areas. For example, under the CDRA "standardized" derivatives would be required to be centrally cleared (as under the Treasury Proposal) through a clearing agency registered with the SEC or a derivatives clearing organization registered with the CFTC, as applicable. They would not, however, be required to be traded on an exchange (or a commodity-based swap execution facility) except in certain circumstances, for example, if offered to persons other than eligible contract participants. The new proposal, like the Treasury Proposal, would leave the term "standardized" to be defined by the SEC and CFTC (each, in consultation with the Board) based on certain objectives, including to "be consistent with the public interest, the protection of investors, the safeguarding of securities and funds, the maintenance of fair competition among market participants and among clearing agencies." Any security-based swap or commodity-based swap not centrally cleared (for example because it was not "standardized") would be required to be reported to a trade repository registered with the SEC or CFTC (or both), as applicable.

The CDRA, like the Treasury Proposal, would regulate certain market participants as "significant security-based (or commodity-based) derivatives market participants." Notably, these definitions generally would encompass "major swap market participants" (and "major security-based swap market participants"), as well as dealers, identified in the Treasury Proposal, but would exclude investment companies registered under the Investment Company Act of 1940, as amended. Notably, also like the Treasury Proposal, the CDRA aims to exclude parties engaged exclusively in certain hedging transactions from regulation as significant market participants, but otherwise includes "buy-side" market participants within the ambit of the proposed new regime.

Significant security-based (or commodity-based) derivatives market participants would be required to register with the SEC or CFTC (or both), as applicable. They (along with clearing agencies and derivatives clearing organizations) would also be subject to certain minimum capital and margin requirements. Banking regulators along with the SEC and CFTC would participate in setting capital requirements for banks that act as clearing agencies, derivatives clearing organizations and significant security-based (or commodity-based) derivatives market participants. Under the new proposal, these significant market participants would also be subject to new, substantial business conduct requirements – with potentially the same standards applying to dealers and other significant market participants.

The SEC would be permitted to establish position limits for security-based swaps and security derivatives. It would also be able to direct self-regulatory organizations ("SROs") to establish position limits for members and members' clients.

The requirements for "eligible contract participants" would be tightened under the CDRA as under the Treasury Proposal. Security-based swaps not between eligible contract participants would only be permitted to be traded on SEC registered exchanges, as well as being required to be registered under the Securities Exchange Act of 1934, as amended. It would be unlawful for any counterparty not an eligible contract participant to enter into a commodity-based swap.

Regulators under the parallel SEC and CFTC regimes would be required to “maintain comparability” between the two regimes, but generally would not be required to make rules jointly. For example, there would no longer be joint SEC-CFTC rulemaking with respect to security futures products. The SEC and CFTC would be required only to consult with each other with respect to defining “standardized,” trade repository regulation, clearing agency/derivative clearing organization regulation, and market manipulation and anti-fraud regulations. They would be required to prescribe jointly business conduct requirements for significant swap-based (and commodity-based) derivatives market participants, but would be able to set independently minimum capital and margin requirements for applicable significant market participants.

Finally, Senator Reed’s proposed legislation would require the SEC and CFTC to promulgate rules to promote “robust” recordkeeping and reporting requirements for significant security-based (or commodity-based) derivatives market participants, as well as clearing agencies, derivatives clearing organizations, trade repositories, commodity-based swap execution facilities and exchanges, in an effort to improve market transparency, efficiency and stability. The agencies would also have broad authority to protect against market manipulation, fraud and “excessive speculation.”

Federal Banking Agencies Issue Proposed Guidance on Correspondent Concentration Risks

The FDIC, FRB, OCC and OTS (the “Agencies”) jointly issued [proposed guidance](#) (the “Proposed Guidance”) concerning correspondent concentration risks. The Agencies state that concentration risks can occur in correspondent relationships when a financial institution (“FI”) engages in a significant volume of activities with another FI. These relationships can result in credit (asset) concentration risks and funding (liability) concentration risks. The Agencies note that correspondent risks represent a lack of risk diversification, and the Proposed Guidance states that the Agencies generally consider credit exposures of more than 25% of Tier 1 capital as concentrations and funding exposures as low as 5% of an FI’s liabilities as concentrations. The Proposed Guidance provides that management of FIs should (1) identify an FI’s aggregate credit and funding exposures to other FIs and their respective affiliates; (2) specify what information, ratios or trends will be monitored for each correspondent; (3) set prudent correspondent concentration limits and tolerances for factors being monitored and plan for managing concentrations in excess of those limits; and (4) conduct an independent analysis before entering into any credit or funding transactions with another FI. The Proposed Guidance would supplement rather than supersede prior regulatory guidance. Comments on the Proposed Guidance are due no later than October 26, 2009.

Comptroller Dugan Makes Presentation Supporting Retention of Strong Uniform National Standards of Consumer Protection for National Banks and Other Federal Financial Services Providers

Comptroller of the Currency John C. Dugan, in an address before Women in Housing and Finance, criticized the Obama administration’s proposed legislation (the “CFPA Act”) currently being considered by Congress that would create the Consumer Financial Protection Agency (the “CFPA”). Comptroller Dugan’s speech focused on the provisions of the CFPA Act that would (a) eliminate certain aspects of state law preemption that have been traditionally enjoyed by national banks and federal savings associations, and

(b) enable state regulators to enforce the provisions of the CFPB Act independently of federal regulators. Comptroller Dugan stated that in his view the elimination of state law preemption and the empowerment of state regulators to enforce the CFPB Act would (i) reverse nearly one hundred and fifty years of the United States' proven success with the "dual banking system," (ii) eliminate the efficiencies created by the current environment of consistent nationwide regulatory standards for national banks and state banks with interstate operations alike, (iii) generally be counterproductive to the CFPB Act's goal of creating strong nationwide consumer protection standards, and (iv) potentially result in regulatory costs and inefficiencies that would be passed on to the consumer.

Traditionally, national banks and federal savings associations have not been subject to most state financial services laws under the doctrine of state law preemption. Examples of state laws that have not applied to national banks and federal savings associations include those that regulate loan terms, require state licenses for banking activities, or impose conditions on deposit or credit relationships. State laws that do not affect the manner or content of traditional national bank activities, such as those laws dealing with contracts, torts, taxation, or zoning, are generally applicable to national banks and savings associations. The CFPB Act seeks to eliminate state law preemption in the consumer financial services area by (A) explicitly granting state legislatures the right to enact legislation that would subject national banks and federal savings associations to more rigorous regulatory standards than those applicable under the substantive provisions of the CFPB Act, and (B) amending the National Bank Act and the Home Owners Loan Act to clarify that Congress does not seek preemption in the consumer financial services area so long as the relevant state laws are more rigorous than the CFPB Act and are not discriminatory with respect to national banks and federal savings associations. Further, the CFPB Act, as proposed, empowers state regulators to enforce the substantive provisions of the CFPB Act.

Comptroller Dugan emphasized that he supports much of the CFPB Act as proposed, most notably the creation of a set of nationwide consumer laws and regulations that would apply to banks and nonbank financial service providers uniformly. However, he argued that the elimination of state law preemption was unwise for a number of reasons. First, he believes that the creation of the CFPB is an opportunity to create consumer protections strong enough to eliminate the need for supplemental protections from state legislatures. Second, he noted that in an era where technology has enabled the market for consumer financial services to become national or at least interstate in scope, inconsistent regulatory standards for banks doing business on an interstate basis are particularly inappropriate. A "balkanized" approach, in Comptroller Dugan's view, would create uncertainty about which regulations apply to a multistate business, including the regulations regarding which terms and disclosures are permissible for a particular product. A national bank doing business in multiple states might not only be burdened with multiple compliance regimes, but be genuinely unsure whether to apply the law of its home state, the law of the domicile of the consumer, or the law of the location where the financial service is provided. The bank may choose to apply the most stringent state law, which, in Comptroller Dugan's view, would result in one state unfairly legislating for all states. Third, Comptroller Dugan believes that giving states the right to enforce the CFPB Act would add a further layer of confusion, as practical enforcement standards would invariably differ among the CFPB itself and the various state regulatory agencies that would have jurisdiction. In the long run, Comptroller Dugan believes that "these uncertainties have the real potential to confuse consumers, subject providers to major new liabilities, and increase the cost of doing business in ways that will be passed on to consumers." Finally, Comptroller Dugan made the point that the elimination of state law preemption may affect not only federally chartered entities such as

national banks, but also state chartered banks that operate in an interstate manner pursuant to the Riegle-Neal Act.

Comptroller Dugan also rejected the most common rationales for the elimination of state law preemption. Most notably, he rejected the premise that state law preemption deprived the states of the chance to enact tougher consumer protection rules that would have prevented predatory and unsafe mortgage loans. Comptroller Dugan argued that national banks have, in general, originated safer loans than state-regulated nonbank lenders. Furthermore, he rejected the argument that “more cops on the beat” was always better for the consumer. He suggested that the limited resources of state regulators were better directed at numerous nonbank financial institutions.

OTHER ITEM OF NOTE

Goodwin Procter Issues Client Alert Discussing Lehman Bankruptcy Court’s Decision Declaring “Bankruptcy Default” Under Swap Agreement to be Unenforceable

Goodwin Procter’s Financial Restructuring, Hedge Funds and Financial Services practices have issued a [Client Alert](#) discussing the decision by U.S. Bankruptcy Judge James Peck ordering Metavante Corporation, a counterparty to Lehman Brothers Special Financing in an interest rate swap transaction, to perform its obligations to pay quarterly fixed amounts owing under the transaction, notwithstanding the “bankruptcy default” of LBSF and its parent.

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