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Goodwin Procter LLP has one of the largest financial services practices in the United States.

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DEVELOPMENTS OF NOTE

President Obama Proposes New Restrictions on the Size and Scope of Financial Institutions

President Obama proposed two new restrictions designed to limit the size and scope of financial institutions. One restriction would limit the scope of a financial institution's activities by barring any insured depository institution, or any financial firm which owns an insured depository institution, from owning, investing in or sponsoring a hedge fund or private equity fund and from engaging in proprietary trading operations unrelated to serving the institution's customers. The proposal did not provide a definition of proprietary trading, which some commentators have asserted may be difficult to distinguish from trading that relates to business conducted for customers.

The other restriction would limit the size of a financial institution through a cap on an institution's nondeposit liabilities. Depository institutions are currently prevented from acquiring another depository institution if such transaction would result in the resulting institution holding more than 10 percent of aggregate U.S.-insured deposits. Financial institutions are allowed to exceed the 10 percent limitation through organic growth. The proposed restriction would supplement the deposit cap and would include such liabilities as non-insured deposits and wholesale funding. The level of the proposed cap has not yet been determined. This restriction is designed to limit the future growth of the largest U.S. financial institutions.

The President's proposal was heavily influenced by former FRB Chairman Paul Volcker, so much so that the President referred to the restriction on proprietary trading as the "Volcker Rule." Many of the details of the proposal remain unclear, and some have asserted that it may prove to be unworkable. The President asked Congress to incorporate these restrictions into its financial regulatory reform legislation. In December 2009, the House of Representatives passed a comprehensive regulatory reform bill which contained broad authority to limit the size and scope of firms that pose a grave threat to the U.S. economy and financial stability. For more on the House bill, please see the December 15, 2009 *Alert*. The Senate Banking Committee is currently working on its version of financial regulatory reform legislation. House Financial Services Chairman Barney Frank stated that "What we're hoping is that [Senate Banking Committee Chairman] Senator Dodd will incorporate them into his bill and we'll push them in conference." Senator Dodd was noncommittal to the President's proposal, stating that he agrees that companies that take risks should not have taxpayer help and that he would study the proposal and give it careful consideration.

It is unclear if these restrictions would apply to the U.S. subsidiaries of foreign institutions, or to the foreign operations of U.S. institutions. Many in the financial services industry fear that these restrictions would create a severe competitive disadvantage for U.S. financial institutions. The Obama administration has also indicated that it may propose further restrictions on bank holding companies that engage in other risk-prone activities.

The *Alert* will continue its coverage of these and other issues concerning financial regulatory reform in future issues.

Federal District Court Grants Summary Judgment in Excessive Fee Case to Mutual Fund Adviser and Affiliated Distributor Based on Offset for Payments Made to Funds under SEC Settlement

The U.S. District Court for the District of Maryland granted summary judgment to a mutual fund adviser and its affiliated distributor (collectively, the "Adviser") in a suit under Section 36(b) of the Investment Company Act of 1940 alleging that the Adviser had breached its fiduciary duty with respect to compensation by allowing various entities to market time the mutual funds it managed (the "Funds") thereby increasing the advisory fees the Adviser received. The Court found for the Adviser on the grounds that a roughly $19 million offset from the Adviser's 2004 settlement of enforcement proceedings brought by the SEC with respect to the market timing activity (the "Settlement") exceeded the amount the plaintiff shareholders could potentially recover under Section 36(b).

The Settlement. Under the Settlement, the Adviser agreed to pay $100 million, consisting of $50 million in disgorgement and $50 million in civil penalties. These amounts were placed in a Fair Fund to be distributed to Fund investors in order of priority for (i) their proportionate share of losses suffered by the Funds due to market timing and (ii) their proportionate share of advisory fees paid by the Funds that suffered losses during the market timing activity, with any amount not distributed to individual investors credited to the Funds themselves. As a result, the Funds received approximately $19 million from the Fair Fund. The Settlement also provided that in a private damages action brought against the Adviser by or on behalf of one or more investors based on substantially the same facts as those addressed in the Settlement, the Adviser could claim an offset only for monies paid under the disgorgement portion of the Fair Fund. The Court had previously granted

summary judgment on some of the investor claims against the Adviser based on a $21 million offset for civil liability from the amounts paid into the Fair Fund.

Offset. The plaintiffs argued that because individual investors received $61 million prior to any distribution to the Funds, the entire disgorgement had been distributed before any distribution to the Funds had been made; as a consequence, amounts distributed to the Funds were from the civil penalty portion of the Settlement against which no offset was permitted. The Court rejected this argument because it would force an arbitrary decision about the origin of fungible monies and was not consistent with the rationale for permitting the Adviser to claim an offset for the disgorgement amounts paid into the Fair Fund. The Court noted that granting the Adviser a $19 million offset did not threaten the $50 million deterrent of the civil penalty and avoided any potential windfall for the Funds.

Section 36(b) Standard. The Court noted that courts have adopted two different approaches to determining whether an adviser has violated Section 36(b): either (1) they examine whether an adviser has charged a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining; or (2) they examine whether the advisory fee was freely and honestly negotiated on the basis of adequate information disclosed by the adviser. The Court stated that rather than choosing between the two approaches it elected to focus on the issue of scienter, which it had identified as an element of Section 36(b) liability. (The Court acknowledged that it had not found a Section 36(b) case in which the issue of scienter arose, positing that for each of the tests used by courts in Section 36(b) cases, proof of a breach would usually be powerful evidence of an adviser's scienter.) The Court stated that a scienter requirement for Section 36(b) liability was consistent with a widely recognized goal of Section 36(b): "preventing advisers from obtaining excessive fees by exploiting the fact that a typical mutual fund is captive to its adviser because it is organized by its adviser, managed by its adviser, and unable to easily move from one adviser to another." The Court also reasoned that allowing recovery under Section 36(b) in the absence of intentional or reckless adviser misconduct would "allow Section 36(b) to be used to *de facto* challenge the reasonableness of the fees, which is inconsistent with the text and intent of the [sic] Section 36(b)."

Damages. Noting that Section 36(b) permits recovery only for actual damages resulting from an adviser's breach of its fiduciary duty with respect to compensation, the Court found that the Adviser was liable only for the portion of its advisory fees that were disproportionate, excessive or unearned because they were based upon the existence of market timing arrangements or of insider market-timed trades not disclosed when the fees were negotiated. The Court found there was no genuine dispute of fact that the Adviser possessed the requisite scienter only with respect to the advisory fees attributable to the market timing activities it intentionally or recklessly permitted, *i.e.,* the advisory fees attributable to the investment in the Funds made by the entities with which the Adviser was found to have entered into market timing arrangements under the terms of the Settlement. The Court found that those advisory fees amounted to $819,541.

Disposition. Because the approximately $19 million offset to which the Adviser was entitled exceeded the $819,541 the plaintiffs could potentially recover under Section 36(b), the Court found that the Funds had been fully compensated and the plaintiffs could not recover any additional damages under Section 36(b). The Court accordingly granted the Adviser's motion for summary judgment.

OCC Grants Conditional Approval Allowing National Bank to Elect New York Law for Corporate Governance and Reverse Stock Split Purposes

The OCC granted Conditional Approval Letter No. 940 ("Letter #940") allowing a national bank to elect to use New York law with respect to corporate governance procedures, provided that such law is not inconsistent with applicable Federal banking law and regulations. In Letter #940, the OCC also granted conditional approval allowing the national bank to conduct a reverse stock split in accordance with the laws of New York.

12 C.F.R. § 7.2000 expressly allows national banks to elect to follow the corporate governance procedures of the law of the state in which the main office of the bank is located, the law of the state in which the holding company of the bank is incorporated, the Delaware General Corporation Law or the Model Business Corporation Act. In this case, the national bank was able to select New York law for corporate governance purposes because its main office was located in New York.

The OCC, however, had never addressed whether national banks could elect to use the provisions of any state law's corporate governance procedures to effect a reverse stock split. The OCC had previously promulgated 12 C.F.R. § 7.2023, which authorizes national banks to conduct reverse stock splits so long as the reverse stock split is undertaken for a legitimate corporate purpose and provides adequate dissenting shareholders' rights. In Letter #940, the OCC conditionally found that the proposed reverse stock split was legally authorized and met the other statutory criteria for approval. The OCC concluded that the use of New York law was acceptable because New York law included reverse stock split procedures and provided adequate rights to dissenting shareholders. The OCC approved the use of New York law to conduct a reverse stock split with four conditions: (i) the national bank elect the corporate governance provisions of New York law, (ii) the national bank must provide for dissenters' rights comparable to those found in the applicable federal regulations, (iii) the national bank must pay the cost of any appraisal that may occur if any shareholders dissent from the reverse stock split, but not the costs of attorneys' fees incurred by and costs of experts retained by dissenting shareholders, and (iv) if the appropriate court declines to accept jurisdiction of an appraisal action, the national bank will pay the cost of binding arbitration by an independent third party to appraise the stock, but not the costs of attorneys' fees incurred by and costs of experts retained by dissenting shareholders.

FTC Lowers Hart-Scott-Rodino Premerger Notification Thresholds for 2010

The Federal Trade Commission ("FTC") announced that the thresholds that determine whether a transaction is subject to the premerger notification requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSR Act") would be lowered in 2010 from currently prevailing levels. Since 2005, the thresholds have been adjusted annually to reflect changes in U.S. gross domestic product. In general, the HSR Act requires that both acquirors and targets in certain merger, acquisition and similar transactions file a premerger notice with the FTC and the Anti-Trust Division of the Department of Justice if a transaction satisfies certain jurisdictional thresholds.

As modified by the FTC, at the effective date of the revision of the applicable regulation those thresholds for filing a premerger notification will be:

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(1) One party has annual net sales or total assets of at least $126.9 million (formerly $130.3 million);

(2) The other party has annual net sales or total assets of at least $12.7 million (formerly $13.0 million);

(3) As a result of the transaction, the acquiring party will hold an aggregate amount of voting securities and assets of the acquired party valued at more than $63.4 million (formerly $65.2 million) OR (even if 1, 2 and 3 are not met);

(4) As a result of the transaction, the acquiring party will hold an aggregate amount of voting securities and assets of the acquired party valued at more than $253.7 million (formerly $260.7 million), regardless of the sales or assets of the acquiring and acquired party.

Transactions and parts of transactions that may not be consummated unless approved by a federal banking regulator are exempt from HSR Act premerger notification requirements.

The adjusted thresholds will apply to any covered transaction closed on or after February 22, 2010.

FDIC and Bank of England Sign Memorandum of Understanding Regarding Enhanced Cooperation in Resolving Troubled Cross-Border Depository Institutions

The FDIC and the Bank of England signed a memorandum of understanding ("MOU") under the terms of which they have agreed to expand their cooperation when they act to resolve troubled depository institutions that have activities in both the United States and the United Kingdom. In the MOU, the FDIC and the Bank of England stressed the importance of "close and effective communication about the operations of financial institutions [subject to differing national laws], consultation on developing issues, cooperative contingency planning … and supporting the development of appropriate recovery (going concern) and resolution (gone concern) plans."

Under the MOU the FDIC and the Bank of England also agree to work closely with other regulatory authorities in the U.S. and the U.K. in connection with the resolution of troubled cross-border financial institutions. FDIC Chairman Bair stated that the MOU is an important step toward implementing the recommendations of the Basel Committee's Cross Border Resolution Group.

OTHER ITEM OF NOTE

SEC to Act on Money Market Fund Regulations

The agenda for the SEC's open meeting on Wednesday, January 27, 2010 includes action on new rules, rule amendments, and a new form under the Investment Company Act of 1940 governing money market funds.

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