

FINANCIAL SERVICES ALERT

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DEVELOPMENTS OF NOTE

Senator Dodd Releases Revised Financial Regulatory Reform Bill

Senator Christopher Dodd, the Chairman of the Senate Banking Committee, released a revised version of his comprehensive bill to overhaul the regulation of financial products and services, the Restoring American Financial Stability Act of 2010 (the "Dodd Bill"). Among other things, the Dodd Bill would create an independent consumer protection bureau within the FRB, grant the FRB authority over all financial firms with more than \$50 billion in assets, realign the supervision of banks, form an interagency council to identify and address systemic risks; create a new resolution system for large, complex financial institutions, and impose a host of specific requirements including higher capital and leverage standards on large firms that pose a risk to the economy. Senator Dodd first proposed a regulatory reform bill in November 2009 (the "November 2009 Draft"), as discussed in the [November 17, 2009 Alert](#). The Dodd Bill was released after the negotiations between Senator Dodd and Republican Senators Richard Shelby and Bob Corker failed to result in a consensus for a bipartisan financial regulatory reform bill. In December 2009, the House passed its version of a comprehensive financial regulatory reform bill, the Wall Street Reform and Consumer Protection Act of 2009 (the "House Bill"). For more on the House Bill, please see the [December 17, 2009 Alert](#).

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Regulation of Banks and Bank Holding Companies. Under the Dodd Bill, the prudential supervision of banks would be greatly realigned. Like the House Bill, the Dodd Bill would eliminate the OTS, and while existing thrifts would be grandfathered, no new thrift institutions could be chartered. The Dodd Bill, however, would remove certain supervisory powers of the FRB and grant them to the OCC and the FDIC. The OCC would regulate all national banks and federal thrifts (including national bank and federal thrift subsidiaries of bank holding companies with assets of \$50 billion or more) and the holding companies of national banks and federal thrifts with assets of less than \$50 billion. The FDIC would regulate all state-chartered banks and thrifts (including state-chartered bank and thrift subsidiaries of bank holding companies with assets of \$50 billion or more) and all bank holding companies of state banks with assets of less than \$50 billion. If a bank holding company owned both federally- and state-chartered depository institutions, the OCC would regulate the holding company if the assets of the holding company's federally-chartered institutions were greater than those of the company's state-chartered institutions and the FDIC would regulate the holding company if the assets of the company's federally-chartered institutions were greater than those of the company's state-chartered institutions. The FRB would regulate bank and thrift holding companies with assets \$50 billion or more and certain large firms that are important to clearing, payments and settlement systems.

Regulation of Systemic Risk. Similarly to the House Bill, the Dodd Bill would create a Financial Stability Oversight Council (the "Council") chaired by the Treasury Secretary and consisting of the heads of the FRB, the SEC, the CFTC, the OCC, the FDIC, the FHFA and the new consumer financial protection bureau described below and an independent member appointed by the President with experience in the insurance industry. The Council would be tasked with identifying, monitoring and addressing systemic risks posed by large, complex financial firms as well as products and activities that spread risk across the U.S. financial system. It also would recommend that the FRB implement rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity, with greater requirements on companies deemed to pose risks to the U.S. financial system. The Dodd Bill would create an Office of Financial Research within the Treasury to support the Council's data collection and analysis of systemic risks. The Council, by a two-thirds vote, could require nonbank financial companies that would pose a risk to the financial stability of the U.S., if they failed, to be subject to FRB regulation. The Dodd Bill provides that a bank holding company with assets of \$50 billion or more as of January 1, 2010, that received assistance under TARP would be treated as a nonbank financial company subject to supervision by the FRB if such company ceases to be a bank holding company. The FRB, with a two-thirds vote by the Council, could require a large, complex financial company to divest certain assets or terminate certain activities if the FRB determined that such company posed a "grave threat to the financial stability of the United States."

Consumer Financial Protection. The most contentious proposal of both the Dodd Bill and the House Bill has been the idea of an independent consumer financial protection regulator. The House Bill would create an independent agency with rulemaking, examination and enforcement powers, the Consumer Financial Protection Agency. The Dodd Bill, however, would instead establish the Bureau of Consumer Financial Protection (the "Bureau") as an independent division of the FRB with a director appointed by the President and confirmed by the Senate. The Bureau would have rule-making authority for banks and nonbanks, but would only have examination and enforcement powers over banks and credit unions with more than \$10 billion of assets, all mortgage-related businesses (including mortgage

lenders, servicers and brokers) and certain large nonbank financial companies, such as large payday lenders, debt collectors and consumer reporting agencies. Banks and credit unions with less than \$10 billion in assets would continue to be examined by their primary bank regulators. Under the Dodd Bill, the Bureau would have to coordinate with other regulatory agencies when examining banks to prevent undue regulatory burden. It would also consult with the other regulatory agencies before promulgating new regulations to ensure such regulations do not conflict with safety and soundness standards.

Volcker Rule. The Dodd Bill contains provisions that address the Treasury's proposal to ban proprietary trading by banks, known as the "Volcker Rule." For more on the Volcker Rule, please see the [January 26, 2010 Alert](#). The Dodd Bill would require the Federal banking agencies to prohibit such trading as well as restrict investment and relationships with hedge funds and private equity firms, subject to the recommendations and modifications of the Council. Certain nonbank financial companies subject to supervision by the FRB would also have restrictions on proprietary trading and hedge fund and private equity investment. A separate bill to implement the Volcker Rule has also been introduced to the Senate by Senators Merkley and Levin and is discussed below, in this issue of the *Alert*.

OTC Derivatives. The Dodd Bill would create an entirely new federal regulatory regime for over-the-counter and other derivatives. Although the Dodd Bill largely reflects the previous version of Senator Dodd's proposed reforms for derivatives, as discussed in the [November 17, 2009 Alert](#), Senator Dodd's office has announced that Senators Jack Reed and Judd Gregg are working on a substitute amendment to Title VII (the derivatives title) that may have a substantial impact on the proposal considered by the full committee. Like prior proposals from the Treasury, Congressmen Barney Frank and Collin Peterson, Senator Reed and Senator Dodd's own prior proposal, the Dodd Bill would create parallel regimes for swaps, which would be regulated by the CFTC, and security-based swaps, which would be regulated by the SEC. Among other things, the Dodd Bill would create (1) extensive new mandatory clearing and exchange trading requirements for swap and security-based swap transactions; (2) registration requirements and position limits for swap and security-based swap traders and major market participants; and (3) reporting requirements for swap and security-based swap participants and transactions. The Dodd Bill would also require the SEC, the CFTC, the Council and the Treasury to "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation of swaps" and would permit those agencies to agree to information-sharing agreements.

Asset-Backed Securitization Regulation. The Dodd Bill would direct the OCC, the FDIC and the SEC to jointly prescribe regulations requiring an issuer or other securitizer to retain an economic interest in a "material portion" of the credit risk of asset-backed securities and otherwise prohibiting a securitizer from directly or indirectly hedging or otherwise transferring such risk. The regulations would require securitizers to retain not less than five percent of the credit risk for any particular asset. If such securitizers, however, qualify as underwriters in accordance with the new regulations, they may be eligible for an adjustment to or exemption from this risk retention requirement. The Dodd Bill differs from the November 2009 Draft, described generally in the [November 17, 2009 Alert](#), which contained a ten percent risk retention threshold and did not include a partial exemption for underwriters or an exemption for the securitization of assets issued or guaranteed by the federal government or a government-sponsored enterprise such as such as Fannie Mae or Freddie Mac. The Dodd Bill would further amend the Securities Exchange Act of 1934 and

the Securities Act of 1933 to direct the SEC to prescribe regulations requiring disclosure concerning the assets underlying an asset-backed security, as well as the due diligence analysis performed by the issuer.

Resolution of Large, Complex Financial Institutions. Similar to the House Bill, the Dodd Bill would grant the FDIC the authority to resolve large, complex financial institutions. Under the Dodd Bill, the Treasury, the FDIC and the FRB must agree to put a financial company into the liquidation process after a panel of three bankruptcy judges agree, within 24 hours, that the financial company is insolvent. To fund such a resolution, the Dodd Bill would establish a \$50 billion resolution fund, which would be funded by assessments on bank holding companies with assets of \$50 billion or more and any nonbank financial companies subject to supervision by the FRB.

FRB Emergency Lending Authority. The Dodd Bill would reform the FRB's emergency lending authority under Section 13(3) of the Federal Reserve Act by limiting it to "system-wide support" for healthy institutions or systemically important companies during a major destabilizing event. Such authority could not be used to support an individual institution. Under the Dodd Bill, the FRB would be required to disclose within seven days of extending loans under such emergency lending authority the identity of borrowers, collateral, and amounts borrowed "unless doing so would defeat the purpose of the support." The FRB would be able to delay such disclosure by up to a year if it would compromise the program or financial stability.

Private Fund Investment Adviser Registration. The Dodd Bill would (i) effectively require every adviser to "private funds" (including hedge funds, but excluding "venture capital funds" and "private equity funds") with at least \$100 million in assets under management to register with the SEC under the Investment Advisers Act of 1940 ("Advisers Act"), without regard to the adviser's number of clients, and (ii) impose upon registered advisers enhanced recordkeeping and reporting obligations designed to help the SEC and other government agencies identify and monitor threats to the stability of the economy. The Dodd Bill represents relatively modest changes to these aspects of the November 2009 Draft, which were discussed in detail in a [November 20, 2009 Goodwin Procter Client Alert](#). For example, unlike the November 2009 Draft, the Dodd Bill: (i) defines "private funds" solely by reference to the exclusions from the definition of "investment company" under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (and, does not require "private funds" to be either organized under U.S. law or have 10% or more of their outstanding securities owned by U.S. persons); (ii) does not explicitly require "private fund" advisers' to file reports on their use of leverage, trading practices and side letters (such reports must be *maintained*, but not necessarily *filed*); and (iii) grants the SEC authority to require such advisers to "file reports containing such information as the [SEC] deems necessary and appropriate in the public interest for the protection of investors or for the assessment of systemic risk." Like the November 2009 Draft, the Dodd Bill provides Advisers Act registration exemptions for advisers to "private equity funds" and "venture capital funds". Because the SEC must define each of these categories of funds, the scope of these registration exemptions remains unclear.

Investor Protection. The Dodd Bill includes a number of investor protection measures with a particular focus on retail investors. It permanently establishes an Investor Advisory Committee and an Investor Advocate at the SEC, and gives the SEC express authority to conduct testing with investors. The legislation would authorize the SEC to adopt rules under which broker-dealers would be required to provide retail investors with disclosures

specified by the SEC before they purchase an investment product or service. The legislation would also require the SEC to conduct studies of (a) the effectiveness of/gaps in legal and regulatory standards of care applicable to investment professionals dealing with retail investors (and conduct subsequent rulemaking to address any gaps discovered), (b) the financial literacy of retail investors and (c) mutual fund advertising.

Regulatory Enforcement/Remedies. The Dodd Bill would give the SEC rulemaking power over the use and conduct of mandatory arbitration of disputes involving the securities laws and rules of self-regulatory organizations. The Dodd Bill also includes provisions designed to increase protections and incentives for whistleblowers and would expand the scope of collateral bars that the SEC could impose as sanctions.

Executive Compensation. The Dodd Bill addresses the issue of executive compensation in a variety of ways. It would introduce a requirement for a non-binding shareholder vote on executive compensation when proxy materials include certain information on that topic. In addition, the SEC would be required to promulgate rules under which the listing standards for exchanges would mandate (a) compensation committee independence standards and (b) clawback of incentive-based compensation in certain circumstances involving an accounting restatement. The Dodd Bill would also provide for SEC rulemaking to require proxy statement disclosure regarding (i) a compensation committee's use of a compensation consultant, (ii) the relationship between executive compensation and issuer financial performance and (iii) whether board members and employees of an issuer may take positions that hedge or offset declines in the value of the issuer's equity securities they hold.

Corporate Governance. The Dodd Bill would require the SEC to adopt rules under which exchange listing standards would mandate that a director not receiving a majority vote in an uncontested election would have to tender his or her resignation which would then be accepted or rejected by the board according to a specified process. The SEC would also receive express authority to adopt rules granting proxy access for shareholder nominees, and would be required to adopt rules under which an annual proxy statement would have to include an explanation of the reasons an issuer had chosen to have the same person serve as chief executive officer and chairman of the board, or chosen not to do so.

Securities Lending. The Dodd Bill would give the SEC rulemaking authority with respect to securities lending and require it to adopt rules designed to increase the transparency of information regarding securities lending available to broker-dealers and investors.

Credit Rating Agency Regulation. The Dodd Bill addresses a broad range of issues relating to SEC regulation of nationally recognized securities rating organizations ("NRSROs"). Most significantly, the Dodd Bill would create an Office of Credit Ratings within the SEC that would be required to conduct an annual examination of each NRSRO and make its inspection reports publicly available. The SEC would be directed to issue rules under which NRSROs would have to (a) adopt procedures for the development, approval and oversight of credit ratings methodologies and (b) implement related internal controls and reporting to the SEC. The SEC would also be required to adopt rules mandating public disclosures by an NRSRO of (a) quantitative and qualitative information on assumptions, source data and other matters underlying each credit rating (to accompany the rating) and (b) information on the performance of ratings over time. The Dodd Bill would expand the SEC's authority to impose limitations and sanctions on NRSROs, and require them to adopt procedures to address conflicts of interest and provide additional related reporting to the SEC. The Dodd Bill would enable private actions against an NRSRO over credit ratings,

stating that the enforcement and penalty provisions of the Securities Exchange Act of 1934 would apply to statements made by a credit rating agency in the same manner and to the same extent as to statements made by a registered public accounting firm or a securities analyst under the securities laws. The Dodd Bill would also provide for General Accounting Office and federal regulatory agency review of how the use of credit ratings in regulations might be reduced.

Insurance. The Dodd Bill would create an Office of National Insurance (the “ONI”) in the Treasury with limited functions. Primarily, the ONI would (a) monitor the insurance industry and could recommend to the Council that “an insurer, including the affiliates of such insurer,” be subject to supervision by the FRB as discussed above under “Systemic Risk”; and (b) coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters and assist the Secretary of the Treasury in negotiating 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”). The ONI would be empowered to determine, following notice and an opportunity to comment, that state insurance measures are preempted by International Insurance Agreements on Prudential Measures. The Dodd Bill also includes provisions dealing with state regulation of certain aspects of nonadmitted insurance, surplus lines and reinsurance.

The Dodd Bill also contains provisions relating to municipal securities markets regulation, the management, operation and funding of the SEC and the governance of the FRB. Senator Dodd plans to hold hearings on the Dodd Bill during the week of March 22, 2010, in anticipation of taking a committee vote on the bill by March 26, 2010, then the Senate begins a two week recess period. The *Alert* will continue to follow the developments surrounding financial regulatory reform and future issues of the *Alert* will continue further discussion of the proposals contained in the Dodd Bill and any modification made by the Senate Banking Committee and the full Senate.

Senators Merkley and Levin Introduce Bill to Restrict Proprietary Trading by Banks and Large Non-Banks and to Prohibit Conflicts of Interest by Underwriters of Asset-Backed Securities

On March 10, 2010, Senator Jeff Merkley (D-OR) and Senator Carl Levin (D-MI) introduced the Protect our Recovery through Oversight of Proprietary Trading Act (the “PROP Trading Act”), a bill the Senators claim is designed to “make banking boring again.”

The PROP Trading Act would amend the Bank Holding Company Act to prohibit a banking entity from engaging in proprietary trading or taking or retaining any ownership interest in or sponsoring a hedge fund or private equity fund. Specified nonbank financial companies that engage in proprietary trading or that take or retain any ownership interest in or sponsor a hedge fund or private equity fund would be subject to additional capital requirements. Under the PROP Trading Act, the FRB and FDIC, in consultation with the SEC and CFTC, would be tasked with jointly adopting rules to effectuate the new provisions, and the FRB and FDIC would have the authority to exclude any transaction, class of transactions, or certain activities from the new provisions.

The PROP Trading Act would amend the Securities Act to prohibit underwriters, placement agents, initial purchasers or sponsors of asset-backed securities from engaging in any transaction that, while such asset-backed security is outstanding and held by unaffiliated investors, would “give rise to any material conflict of interest with respect to any investor in a transaction arising out of such activity” or “undermine the value, risk, or performance of the asset-backed security.” The SEC would have sole rulemaking authority to impose restrictions on the timing and extent of proprietary trading by an underwriter, placement agent, initial purchaser or sponsor and any affiliates or subsidiaries thereof.

FDIC Extends Securitization Safe Harbor

The FDIC Board of Directors voted to extend until September 30, 2010 the safe harbor provided at 12 C.F.R. §360.6 (the “Safe Harbor”) from the FDIC’s ability, as conservator or receiver, to recover assets securitized or participated out by a federally insured depository institution (an “IDI”). This extension of the interim rule issued on November 13, 2009 (the “Interim Rule”), which would have expired on March 31, 2010 (See the [November 17, 2009 Alert](#)), permanently grandfathers all securitization or participation contracts closed through September 30, 2010.

The FDIC issued the Interim Rule in order to address questions over the continuing availability of the Safe Harbor in light of certain changes to generally accepted accounting principles that made it impossible for some participations and most securitizations to satisfy the requirements of the Safe Harbor (absent the Interim Rule). These changes, set forth in FAS 166 and FAS 167, amend FAS 140 and FAS 46(R), and could have resulted in many securitizations and some participations being treated as secured borrowings rather than as sales for accounting purposes. Therefore, absent relief, many securitizations originated by IDIs after November 15, 2009 (the effective date of the accounting rule changes) would not have satisfied the requirements of the Safe Harbor (See the [June 16, 2009 Alert](#)).

The FDIC’s December 2009 advanced notice of proposed rulemaking, which proposed extensive amendments to the Safe Harbor on a permanent basis, garnered extensive public comment. Therefore, the FDIC is extending the Interim Rule to allow additional time to finalize the permanent changes to the Safe Harbor.

Federal District Court Dismisses Class Action Suit Alleging Securities Fraud Related to Mutual Fund’s Mortgage Securities Holdings

The U. S. District Court for the Southern District of New York (the “Court”) granted a motion to dismiss a class action lawsuit filed by mutual fund investors against the sponsor and investment adviser of the fund, certain executives of the investment adviser and the fund’s trustees asserting fraud and misrepresentation claims under Sections 11 and 12(a)(2) of the Securities Act of 1933 and control person liability under Section 15 of that Act. The plaintiffs alleged that the defendants misrepresented the nature, extent and consequences of the fund’s investments in mortgage-related securities. The Court granted the defendants’ motion to dismiss the plaintiffs’ amended complaint because it failed to plead actionable material misrepresentations in the fund’s offering documents.

Background. During the period between July 2005 and May 2008, the fund’s net asset value (“NAV”) fell 34%. According to the complaint, the decline was due to large write-downs to the value of the fund’s mortgage-related holdings. The fund was ultimately liquidated on May 30, 2008. The plaintiffs’ complaint alleged that the fund’s offering

documents mislead investors in three ways: (i) a misleading description of the fund's investment strategy; (ii) misrepresentation of the extent of the fund's exposure to mortgage-related securities; and (iii) inflated valuations of the fund's mortgage-related securities, which led to overstatements of the fund's NAV.

The Court's Findings.

1. *Fund Description.* The fund's prospectus described its non-fundamental investment objective as to "seek high current income and liquidity by investing primarily in a diversified portfolio of high-quality debt securities...." The plaintiffs alleged that this description was materially false because the fund was invested primarily in risky mortgage-related investments. The Court found that the complaint did not adequately plead falsity.

In reaching its conclusion, the Court compared and contrasted the investment objective of the fund to the investment objective of a money market fund included in the same prospectus, which had an objective to maximize current income to the extent consistent with the preservation of capital and liquidity. The Court noted that the two descriptions that appeared near to each other indicates that the "high-quality" language cannot be read as an implicit representation that the fund posed little or no risk. The Court interpreted "high-quality" to mean a description of the related credit grade of the fund's holdings and cited disclosure in the fund's prospectus that described the holdings as 80% rated in the two highest Standard & Poor's rating categories, "AAA" or "AA." The Court found that the fund's portfolio complied with the description of the fund's investment objectives and the nature of its securities and that the complaint made no factual allegations about the fund's mortgage-related holdings. For example, the complaint did not include other facts by which the quality of the mortgage-related securities might be judged or allege that the fund's holdings fell within a "low-quality" subset of the mortgage-related sector.

The plaintiffs alleged that the "high-quality" description conflicted with contemporaneous market information about the developing subprime mortgage crisis. The Court stated that the accuracy of the statements must be assessed in light of information available at the time the documents were published. At a minimum, the Court stated that the complaint must plead facts to demonstrate that the alleged omitted facts both existed and were knowable at the time of the offering.

The Court stated that even assuming that the allegations show that the fund's reference to "high-quality ... investment grade debt instruments, such as mortgage-related securities," to be false, the plaintiffs failed to allege that the general statement was material within the context of the totality of the information available in the prospectus and marketplace. The Court stated that the plaintiffs could not claim that the defendants misled them as to information readily available in the public domain.

2. *Exposure to Mortgage-Related Securities.* The plaintiffs alleged that the fund's offering documents misrepresented the extent to which the fund invested in mortgage-related securities. The fund's annual report disclosed the percentage of the fund's portfolio securities that was comprised of "asset-backed securities," "mortgage-backed securities" and "international debt." The complaint stated that some of the mortgage-related securities were incorrectly characterized as asset-backed securities. The Court noted the defendants' definition of "mortgage-backed securities" included in the prospectus as

instruments backed by first mortgages or first deeds of trust, therefore, implicitly, excluding other types of mortgage-related instruments from the mortgage-backed securities category.

The Court found that the annual report's percentage breakdown appeared to be accurate because the mortgage-backed securities category, consistent with the definition in the prospectus, did not include all mortgage-related securities. The Court also noted that the complaint did not plead that the misrepresentation was material. A claim under Section 11 and 12(a)(2) must plead materiality of the alleged misrepresentation or omission. To be material, the Court noted that the complaint should have included information about the "miscategorized" securities to show that the table, describing the percentage of holdings in the various categories, distorted the fund's risk profile or that its inaccuracy would have otherwise been significant to a reasonable investor deciding how to act. Because the plaintiffs did not allege facts sufficient to plead that the categorizations were materially misleading, the Court stated that the claim must be dismissed. The Court also noted that the table in question was not prominently displayed and that detailed schedules for each category included the names of the securities. Given the total mix of information, the Court did not think that a reasonable investor would believe that the "mortgage-backed securities" category represented the extent of the fund's mortgage holdings. Even if the table was inaccurate in isolation, the Court found that the inaccuracy was immaterial as a matter of law.

3. *Inflated Valuations of Mortgage-Related Securities.* The plaintiffs alleged that the fund overstated the value of its mortgage-related holdings, which caused the fund to overstate its NAV. The Court acknowledged that there is no single, objectively acceptable method for valuing complex instruments at issue in the complaint, and noted that valuation of mortgage-backed securities involves the exercise of judgment. The Court then considered the fund's description of its valuation methodology and stated that the defendants' valuations could only be false and misleading if they were inconsistent with the described methods. The Court found that the plaintiffs' claim fails because the plaintiffs did not allege any facts to suggest that the defendants deviated from the prescribed valuation methods. The plaintiffs did not allege facts about which securities were overvalued or how any valuation conflicted with the procedures described in the prospectus. The Court also stated that the fact the fund eventually took large write-downs on its mortgage-related securities does not stand for the proposition that the values stated before the write-down were inaccurate. Because the plaintiffs did not allege facts about how the value of the fund's mortgage-related holdings conflicted with the defendant's valuations, the Court dismissed the third claim.

Final Disposition. Because the plaintiffs did not request leave to replead, and because they had amended the complaint once already, the Court dismissed all the claims with prejudice.

Federal District Court Denies Motion to Dismiss ERISA Class Action Claims Challenging Bank's Inclusion of Affiliated Mutual Funds and Company Stock in Its Retirement Plans

In *In re Regions Morgan Keegan ERISA Litig.*, Case No. 08-2192 (W.D. Tenn. Mar. 9, 2010), the U.S. District Court for the Western District of Tennessee denied a motion to dismiss ERISA breach of fiduciary duty claims involving a bank's inclusion of affiliated mutual funds and a company stock fund in its retirement plan.

Plaintiffs, current and former employee participants in 401(k) plans sponsored and administered by a consumer and commercial banking firm, filed a class action suit alleging that plan fiduciaries breached duties owed under ERISA by (1) including mutual funds advised and distributed by affiliates in the plans for the improper purpose of generating income for defendants; (2) selecting proprietary bond funds for inclusion in the plans that were overexposed to high-risk assets such as subprime mortgage-backed securities; and (3) offering the plan sponsor's stock as an investment option when the stock was an imprudent selection due to the bank's "improper and extremely risky business activities" in the subprime mortgage market. The complaint named as defendants the plan sponsor, its affiliated broker-dealer and mutual fund investment adviser, as well as several individuals who performed functions with respect to the plans.

Use of Proprietary Funds. Plaintiffs in their complaint alleged that defendants breached fiduciary duties and engaged in prohibited transactions by selecting for the plans mutual funds affiliated with the bank for the purpose of generating a profit to the bank and its related entities. With respect to their prudence claim, plaintiffs asserted that the funds charged excessive fees and that plan fiduciaries had failed to use the plans' bargaining power to secure lower costs. The court held that plaintiffs had adequately pleaded these claims by pleading, among other allegations, that defendants selected retail share classes over investor share classes, and that the expense ratios for selected funds were in some instances six times the expense ratio for "readily available comparable funds." With respect to the prohibited transaction claims, plaintiffs alleged that defendants engaged in self-dealing at the expense of the plans by including mutual funds that paid "revenue sharing and other kickback payments" to defendants. Defendants argued in their motion to dismiss that the DOL's Prohibited Transaction Exemption 77-3 ("PTE 77-3") precludes liability insofar as the exemption permits, under certain conditions, the acquisition or sale of shares of mutual funds by a plan covering employees of the mutual fund's manager or principal underwriter and its affiliates (*i.e.*, "in-house plans"). (For a discussion of PTE 77-3 and related Department of Labor Advisory Opinion 2006-06A, see the [August 8, 2006 Alert](#).) The court declined to address on the pleadings whether the exemption applied, noting that favorable decisions cited by defendants regarding when PTE 77-3 should apply address motions for summary judgment, brought after discovery had been taken. Accordingly, the court denied defendants' motion to dismiss on this ground.

Inclusion of Bond Funds. Plaintiffs alleged that defendants violated ERISA by offering proprietary bond funds that, while described as holding low to moderate risk portfolios, were heavily exposed to high risk assets. In moving to dismiss, defendants argued that, under principles of modern portfolio theory, the plans should include investments with low risk/return characteristics, as well as other investments with high risk/return characteristics, and that no particular investment option should be viewed in isolation in determining fiduciary prudence. Citing plaintiffs' allegations that defendants knew or should have known that investments in the bond funds were imprudent because the funds were advised by an affiliate of the sponsor, the court concluded that plaintiffs had adequately stated claims with respect to those funds.

Employer Stock Claims. Plaintiffs also alleged that it was a breach of ERISA fiduciary duty to include the employer's own stock as an investment option in the 401(k) plans given the decline in the stock price due to sub-prime related exposures. Defendants moved to dismiss these claims on the ground that plan fiduciaries were entitled to the "presumption of prudence" that attaches to the selection of employer stock for inclusion in retirement plans. Defendants cited ERISA § 404(a)(2), which provides that ERISA's duties of diversification

and prudence are not violated by a plan's acquisition or holding of qualifying employer securities, and ERISA § 407(b)(1), which exempts plans from limits placed on ownership of employer securities. The district court declined to decide on a motion to dismiss whether the presumption of prudence should apply to the facts of the case, citing a recent amicus brief filed by the Department of Labor ("DOL") in a case pending before the Second Circuit in which the DOL argues that it is improper to apply the presumption of prudence at the pleadings stage. (The DOL position will be discussed in greater detail in the forthcoming edition of the ERISA Litigation Update, expected later this week.) The court also held that plaintiffs had adequately pleaded that defendants breached their ERISA disclosure obligations by allegedly failing to accurately disclose the plan sponsor's financial condition.

Disposition. The court granted dismissal of one count of co-fiduciary liability against the affiliated broker-dealer and investment adviser defendants relating to the company stock fund on the ground that those parties were not alleged to have been involved in the relevant challenged conduct. Plaintiffs' claims were otherwise sustained.

CFTC Grants No-Action Relief from CPO Registration Requirements in Context of Common Control Entities

The CFTC's Division of Clearing and Intermediary Oversight provided [no-action relief](#) from the requirement that each entity in a group under common ownership and control register as a commodity pool operator ("CPO") in order to serve as the managing member, general partner or sole voting shareholder of a fund. The various entities in the group were created to facilitate favorable tax treatment of performance allocations paid by the funds. In seeking the relief, among other things, the members of the group represented that (a) they would delegate all discretionary authority with respect to the funds to a member of the group that is registered as CPO of the funds, (b) the members of the group would submit to the Division a written acknowledgement of joint and several liability for a violation by any of them of the Commodity Exchange Act or CFTC rules, and (c) they would comply with other conditions on their personnel and the scope of their activities with respect to the funds.

FRBNY Announces Eligibility of Certain Money Market Funds for Reverse Repurchase Program

The Federal Reserve Bank of New York (the "FRBNY") announced that money market funds that meet certain criteria may be eligible counterparties in a possible Federal Reserve Bank-sponsored reverse repurchase program intended to drain reserves from the U.S. financial system. Previously, only the eighteen primary government securities dealers reporting to the Government Securities Dealers Statistics Unit of the FRBNY had been considered as eligible counterparties for the proposed program. To be eligible, a money market fund must, among other things: (a) be registered with the SEC as an open-end management investment company, (b) be in compliance with Rule 2a-7 under the Investment Company Act of 1940, the SEC rule that sets forth certain risk-limiting conditions on a money market fund's portfolio, as well as certain other conditions designed to allow the fund to maintain a stable share price, (c) have been in existence for at least one year, and (d) have net assets of at least \$20 billion for the previous six consecutive months.

A money market fund that intends to participate in the program must submit its initial application to the FRBNY by March 19, 2010. The FRBNY expects to notify all applicants

by March 26, 2010. If the FRBNY deems that a fund meets the eligibility criteria, the fund will be asked to submit additional materials by April 2, 2010. The FRBNY has said that it expects that it will take at least one month to consider a fund's complete application, which will include a review of the fund's compliance program, discussions with the fund's compliance and credit risk management staff, discussions with senior management about the fund's financial condition and ability to meet the FRBNY's business needs, a review of financial information, and consultation with primary supervisors and regulators.

Federal Banking Agencies Revise CRA Guidance to Allow Pro Rata Credit for Mixed-Income Housing

The FDIC, FRB, OCC, and OTS (the "Agencies") published revisions to the *Interagency Questions and Answers Regarding Community Reinvestment* ("Q&As"). After considering comments received, the Agencies adopted one new and two revised Q&As that were proposed on January 6, 2009. The new Q&A provides examples of how to demonstrate that community development services meet the criteria of serving low- and moderate-income areas and people when actual income is not available. The two revised Q&As enable consideration of a pro rata share of mixed-income affordable housing projects as community development projects. The first revised Q&A addresses when an activity can be considered to have a "primary purpose" of community development. Activities related to the provision of mixed-income housing—such as a development that has an affordable housing set-aside for low- and moderate-income individuals—would be considered community development activities, and an institution may receive pro rata consideration for the dollar amount of the loan or investment based on the percent of units set aside for affordable housing for low- or moderate-income individuals. (As in the past, when the express, bona fide intent of an activity is community development, such as for the Low-income Housing Tax Credit Program, the full amount will be considered.) The second revised Q&A adjusts reporting requirements for community development loans to address the percentage of units set aside for low- or moderate-income individuals. Separately, the Agencies declined to adopt a recommendation that banks receive favorable consideration for providing financial literacy education to primary – and secondary – school students.

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