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## DEVELOPMENTS OF NOTE

### U.S. Supreme Court Issues Decision in Mutual Fund Excessive Fee Case

This afternoon, the U.S. Supreme Court (the "Supreme Court") issued its [opinion](#) vacating the Seventh Circuit's decision in *Jones v. Harris Associates L.P.*, 527 F.3d 627 (7th Cir. 2008), an excessive fee suit under Section 36(b) of the Investment Company Act of 1940. (For background on this case, see the [March 10, 2009](#) and [June 3, 2008 Alerts](#).) In broad terms, the Supreme Court unanimously endorsed the multi-factor approach to Section 36(b) established by the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982) and rejected the Seventh Circuit's approach to Section 36(b), which focused almost exclusively on a fund adviser's disclosures in connection with the fee approval process. A future edition of the *Alert* will provide a full discussion of this decision.

### Covered Bond Legislation Introduced in the House of Representatives

Covered bonds are back on legislators' lists of bank financing alternatives. Long an integral part of the European financial markets, covered bonds figured prominently on U.S. regulators' radar in 2008, until the potential opportunity they offered was eclipsed by a deepening credit crisis. The FDIC issued, on July 15, 2008, the first formal guidance on covered bonds, the "Final Covered Bond Policy Statement" (the "Covered Bonds Statement"), following several months of comment on its April 23, 2008 "Interim Final Covered Bond Policy Statement" (the "Interim Covered Bond Statement"). Less than two

weeks later, on July 28, 2008, the Department of the Treasury (“Treasury”) published “Best Practices Guide for US Residential Covered Bonds” (the “Covered Bond Best Practices”). Both the FDIC’s Covered Bond Statement and Treasury’s Covered Bond Best Practices focused on providing guidance for what are generally referred to as structured covered bonds rather than statutory covered bonds since both addressed covered bonds that relied on structuring and regulatory guidance rather than a statute.

The United States Covered Bond Act of 2010 (the “Covered Bond Act” or the “Act”) introduced on March 18, 2010 by Representative Scott Garrett, along with co-sponsors Representative Paul E. Kanjorski and Financial Services Committee Ranking Member Spencer Bachus, however, would provide a U.S. statutory framework for covered bonds potentially similar to that afforded certain European covered bonds and offer a financing alternative for a range of asset classes. Under the Act, the Secretary of Treasury (or other appointed officer of Treasury) would oversee the regulation of the covered bond market, including authorization to approve all covered bond programs launched in the market, following mandatory consultation with the potential issuer’s applicable federal regulator (referred to here, generally as the “Federal Bank Regulator”). Treasury’s Covered Bond Best Practices, which incorporates guidance from the FDIC’s Covered Bond Statement, may provide insight into Treasury’s covered bond regime should the Covered Bond Act be enacted. Highlights of the Covered Bond Act follow.

#### ***What covered bonds would be subject to the Act?***

The Covered Bond Act would apply to and govern only a covered bond that is a senior recourse debt obligation of an “eligible issuer” that (i) has an original term of not less than one year, (ii) is secured directly or indirectly by a perfected security interest in a “cover pool” owned directly or indirectly by the issuer, (iii) is issued under a “covered bond program” that has been approved by Treasury and identified in a public register maintained by Treasury, and (iv) is not a deposit (as defined in Section 3 of the Federal Deposit Insurance Act). Notably, the Act itself would not impose a maximum maturity as the Covered Bond Statement had (30 years, increased from a maximum maturity of 10 years under the Interim Covered Bond Statement). Eligible issuers would be insured depository institutions and their subsidiaries, bank holding companies and thrift holding companies, and vehicles established solely to issue covered bonds and sponsored by one or more otherwise eligible issuers. This third category might provide options for a number of smaller banks each of which might be too small to sponsor a covered bond program on its own.

#### ***What happens on default and insolvency, conservatorship or receivership?***

One of the key features of a covered bond is that, while the bond’s issuer (or sponsor, in the case of a special purpose issuer) owns the cover pool and pays interest from its general income, the covered bond is backed by an identified pool of high quality assets. Bondholders have recourse to that cover pool if the bond defaults or the issuer becomes insolvent or subject to a conservatorship or receivership (or similar proceeding); and, if the pool is inadequate to cover the issuer’s obligations on the bonds, bondholders have an unsecured claim against the issuer (or the FDIC, as conservator or receiver, or other applicable estate or party). In keeping with this typical covered bond structure, the Covered Bond Act would establish the automatic creation, by operation of law, of an estate comprised of the cover pool (the “Cover Pool Estate”) upon (i) if prior to the insolvency, conservatorship or receivership (or similar proceeding) of the issuer, a default of the

covered bond and (ii) an insolvency, conservatorship or receivership (or similar proceeding) of the covered bond issuer.

***Default of Covered Bonds.*** Upon a default on the covered bonds, the cover pool would be “automatically released to and held by [the] estate free and clear of any right, title, interest, or claim of the issuer or any conservator, receiver, liquidating agent or trustee in bankruptcy.” The issuer, however, would retain a residual interest representing a right to any surplus from the cover pool after all liabilities would have been paid in full. The Cover Pool Estate would be “fully liable” on the covered bonds and any related obligations. Notwithstanding the creation of the Cover Pool Estate, bondholders would retain claims against the issuer for any deficiency on the covered bonds or related obligations. At the election of Treasury, the issuer would be obligated to continue to service the cover pool for a maximum of 120 days after the creation of the estate in exchange for a fair market value fee. Notably, if a covered bond failed mandatory asset-coverage tests after its issuance, it would continue to be subject to the Act. Under the proposed statute, an issuer would have one month to cure its failure to meet its asset-coverage test before such failure would result in the creation of a Covered Pool Estate.

***Insolvency of Covered Bond Issuers.*** In the event the FDIC were appointed as receiver or conservator of the issuer prior to a default under the issuer’s covered bonds, the FDIC would have the option to elect, within 15 days, to transfer any cover pool in its entirety to another eligible issuer. During such 15-day period, the FDIC would be required to satisfy all outstanding obligations of the issuer. (This is a significant difference from the FDIC’s Covered Bond Statement, which could potentially leave bondholders with no right to interest for a 10-day period.) If the FDIC were able to transfer the covered bonds (and respective cover pools), the transferee would become responsible for all outstanding obligations of the original issuer. If the FDIC were unable to transfer the covered bonds and related cover pool to an eligible issuer, a Cover Pool Estate would be automatically created with the residual interest being retained by the conservator, receiver, liquidating agent or bankruptcy estate, as applicable. As where the bonds have defaulted, if a Cover Pool Estate were created, at the election of Treasury, the issuer would be obligated to continue to service the cover pool for up to 120 days after the creation of the Cover Pool Estate, and Treasury would be authorized to act as trustee of the estate and appoint one or more servicers which would have broad powers to manage the assets of the Cover Pool Estate.

#### ***What assets are eligible for a covered bond program under the Act?***

Unlike under many mortgage-backed and asset-backed securities, a covered bond’s cover pool would be a dynamic pool of assets comprised of “eligible assets” from any single “eligible asset class,” “substitute assets” and “ancillary assets.” Eligible assets would be identified in the Act with respect to each eligible asset class and could not be delinquent more than 60 consecutive days (in the case of loans) or be rated less than the highest investment grade rating (in the case of securities). The Covered Bond Act would establish the following eight eligible asset classes:

- *Residential Mortgage Asset Class* would include first-lien mortgages secured by 1-to-4 family residential property, mortgage loans insured under the National Housing Act, loans guaranteed, insured or made under Chapter 37 of Title 38 of the United States Code and residential mortgage-based securities (“RMBS”) of the same asset class.

- *Home Equity Asset Class* would include home equity loans secured by 1-to-4 family residential property and asset-backed securities (“ABS”) of the same asset class.
- *Commercial Mortgage Asset Class* would include commercial mortgage loans and commercial mortgage-backed securities (“CMBS”) of the same asset class.
- *Public Sector Asset Class* would include investment-grade securities issued by one or more states or municipalities, loans made to one or more states or municipalities and loans, securities or other obligations that are insured or guaranteed, in full or substantially in full, by the full faith and credit of the United States.
- *Auto Asset Class* would include auto loans or leases and ABS of the same asset class.
- *Student Loan Asset Class* would include student loans (whether or not such loans are guaranteed) and ABS of the same asset class.
- *Credit or Charge Card Asset Class* would include credit or charge card loans and ABS of the same asset class.
- *Small Business Asset Class* would include loans made under a program established by the Small Business Administration (whether or not such loans are guaranteed) and ABS of the same asset class.

The ABS, CMBS or RMBS included in any eligible asset class would be required to have the highest investment grade rating and could not exceed 20 percent of the outstanding principal of the assets in a cover pool. All loans that are eligible assets would be required to be in compliance with supervisory guidance applicable at the time of their origination. At its option, Treasury would be authorized to designate additional eligible asset classes and corresponding eligible assets. Substitute assets would include cash, direct obligations of the U.S. government, obligations, with the highest investment grade credit rating, guaranteed by the U.S. government, as well as direct obligations of U.S. government corporations and U.S. government sponsored enterprises and obligations, with the highest investment grade credit ratings, guaranteed by U.S. government corporations and U.S. government sponsored enterprises. Ancillary assets would include, in each case related to other assets in the cover pool, interest rate and currency swaps, credit enhancement and liquidity arrangements, guarantees, letter-of-credit rights and other secondary obligations supporting payment or performance of an asset, and proceeds.

***Over-collateralization, Monitoring and Testing.*** Treasury would be required to establish minimum over-collateralization requirements based on the credit, collection and interest rate risks of each eligible asset class, but not the liquidity risks associated with such class. In doing so, Treasury would be authorized to rely on established Federal Reserve over-collateralization levels. Each covered bond issuance would be required to maintain minimum asset coverage at all times and be subject to monthly testing based on these statutory minimum levels (apparently in addition to contractual levels).

The Covered Bond Act would require an issuer to disclose over-collateralization test results to its Federal Bank Regulator, Treasury and the bondholders. Each issuer would also be required to appoint an independent trustee or asset monitor, which would, among other things, monitor a cover pool’s compliance with applicable asset-coverage tests, at least annually, and report those results to the issuer’s Federal Bank Regulator, Treasury and the

bondholders. Additionally, issuers would be required to deliver to the indenture trustee, at least monthly, a schedule of eligible assets in the applicable cover pool.

**Disclosure and Reporting.** Treasury would be required, under the Covered Bond Act, to maintain a publicly available registry of each approved covered bond program and all covered bonds issued under those programs. In addition issuers would be required to register publicly-offered covered bonds unless the bonds were exempted securities and comply with substantial disclosure requirements at issuance and while the covered bond is outstanding. Covered bonds would be permitted to be offered to the public and in private placements. Registration of covered bonds offered by a bank (or bank subsidiary) issuer, and the information required to be disclosed in connection with offering the covered bonds issued by a bank (or bank subsidiary) issuer, would be subject to securities regulations issued by the Federal Bank Regulator of that bank (or bank subsidiary) and applicable antifraud rules, but such covered bonds would be exempt from other federal securities laws. Similar provisions would apply to covered bonds offered by issuers with multiple sponsors who were banks and had the same Federal Bank Regulator. Where the covered bonds were offered to the public and not otherwise exempted securities, however, the Act would mandate that the SEC “develop a streamlined registration scheme.” Disclosure at offering would be subject to compliance with that streamlined scheme and applicable antifraud rules.

### **FDIC Revises Q&As on Brokered Deposit Restrictions and Deposit Rate Limits**

The FDIC issued revised questions and answers (the “Q&As”) regarding the process under Section 29 of the Federal Deposit Insurance Act and Section 337.6 of the FDIC Rules and Regulations (“Section 337.6”) for determining whether a FDIC-insured depository institution (“DI”) is operating in a “high-rate area.” The Q&As provide clarification to the financial institution letter (“[FIL-69-2009](#)”) issued by the FDIC providing guidance on such determinations to DIs that are subject to interest rate restrictions. [FIL-69-2009](#) updated FDIC guidance previously provided in [FIL-62-2009](#).

As described in the [November 17, 2009 Alert](#) and [December 8, 2009 Alert](#), Section 337.6 restricts the use of brokered deposits and limits interest rates paid on interest-bearing deposits solicited by less than well-capitalized DIs and DIs that meet the quantitative tests for being “well-capitalized,” but are subject to a capital maintenance provision issued by a federal banking agency within a formal written agreement, consent order, order to cease and desist, capital directive or prompt corrective action directive.

The Q&As provide clarifications and additional information with respect to the restrictions on interest rates and the process for seeking a determination that a DI is in a high-rate area. The Q&As state that the FDIC recognizes that in the current environment, the spread between the funding costs for community DIs and larger DIs has widened in a way that reflects a variety of factors, including market perceptions about the likelihood of government support for DIs of various sizes. The FDIC notes, however, that the materiality of this issue will vary across different geographic areas. Accordingly, the Q&As provide that in calculating prevailing local interest rates and comparing these to the national rate for the purpose of identifying high cost areas, the FDIC will, when appropriate, exclude the rates offered by multiple branches of the DI.

The FDIC revised its response to the question of whether the cost of gifts or premiums that a DI gives for opening a deposit account should be included in the calculation of the deposit interest rate. Previously, the FDIC required the cost of all gifts to be included. The Q&As

provide that small gifts of premiums - with a value of \$10 or \$20 - may not qualify as interest. The Q&As also clarify that a market area must be a geographic area that includes all DI competitors and cannot consist of a subset of DIs with similar characteristics, such as asset size or a retail focus.

### **First Circuit Dismisses SEC's Rule 10b-5 Claim Against Executives of Mutual Fund's Principal Underwriter Over Alleged Misstatements in Fund Prospectuses**

In an opinion issued on March 10, 2010, an *en banc* panel of the U.S. Court of Appeals for the First Circuit (the "First Circuit") held that certain executive officers of a mutual fund underwriter and distributor could not be primarily liable under Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)") and Rule 10b-5(b) promulgated thereunder, for alleged materially misleading statements in the funds' prospectuses. *SEC v. Tambone*, United States Court of Appeals for the First Circuit, No. 07-1384 (March 10, 2010). The SEC's cause of action under Section 10(b) and Rule 10b-5(b) related to allegations that certain fund investors had been allowed to "market-time" their trades, despite language in the funds' prospectuses prohibiting such activity.

*Procedural Posture.* The U.S. District Court for the District of Massachusetts (the "District Court") dismissed all causes of action against Defendants. A First Circuit panel reversed. Defendants filed petitions for *en banc* review, and the full First Circuit withdrew the panel opinion, though it ordered a rehearing only on the Rule 10b-5(b) issue.

*The SEC's Claim.* Rule 10b-5(b) makes it "unlawful for any person . . . [t]o make any untrue statement of a material fact . . . in connection with the purchase or sale of any security." The SEC argued that Defendants *made* misrepresentations by distributing prospectuses that contained allegedly material misrepresentations. Defendants, according to the SEC, had a "special duty" to investigate the truthfulness of the prospectuses that they distributed, and therefore Defendants impliedly vouched for the truthfulness of the prospectuses.

*The Court's Analysis.* The Court rejected the SEC's argument. First, the Court held that because Rule 10b-5 does not define "make," the term must be interpreted according to its ordinary meaning, and, as commonly understood, to "make" a statement does not mean to adopt another person's statement. Second, the Court noted that by proscribing only the "mak[ing]" of untrue statements of material fact, the drafters of Rule 10b-5(b) deliberately chose to narrow the scope of liability permitted under Section 10(b), which authorizes the SEC to prohibit all conduct that "use[s] or employ[s]" any "manipulative or deceptive device or contrivance." Rule 10b-5's language is largely parallel to that of Section 17(a) of the Securities Act of 1933, with the exception that Section 17(a)(2) prohibits "obtain[ing] money or property *by means of* any untrue statement of material fact (emphasis added)." The Court held that "[t]he drafters [of Rule 10b-5(b)] easily could have copied that language. They declined to do so." Thus, the Court rejected the SEC's "implied representation" theory of liability: that a securities professional that directs the offering and sale of securities on behalf of an underwriter "makes" a statement subject to liability under Rule 10b-5 by implying that the securities professional has a reasonable basis to believe that the key representations in the prospectuses are truthful and complete.

Finally, the Court held that adopting the SEC's proposed interpretation of Rule 10b-5(b) would vitiate the Supreme Court's carefully crafted distinction between primary and secondary securities violations as laid out in *Central Bank of Denver v. First Interstate*

*Bank of Denver*, 511 U.S. 164 (1994). While the government may bring suit under Rule 10b-5 against both primary and secondary violators, private plaintiffs may only pursue primary violators of the statute. “If *Central Bank*’s carefully drawn circumscription of the private right of action is not to be hollowed – and we do not think that it should be – courts must be vigilant to ensure that secondary violations are not shoehorned into the category reserved for primary violations.”

Therefore, the Court affirmed the District Court’s dismissal of the SEC’s Rule 10b-5 claim. The Court concluded: “This is one of those happy occasions when the language and structure of a rule, the statutory framework that it implements, and the teachings of the Supreme Court coalesce to provide a well-lit decisional path.” The Court also reinstated the panel’s decision allowing the SEC to go forward with its claim under Section 17(a)(2) and an aiding and abetting claim under Rule 10b-5.

### **OCC Issues Interpretive Letter Concluding that National Bank, Which Elected Tennessee Law for Corporate Governance, May Reclassify Common Stock into New Classes of Preferred Stock**

The OCC issued an interpretive letter (“Letter #1125”) in which it concluded that a national bank (the “Bank”), which elected to use Tennessee law for corporate governance purposes under 12 C.F.R. §7.2000(b), may reclassify common stock held by the Bank’s shareholders into two new classes of preferred stock. The Bank desires to reclassify its shares of stock so that it can “transform from a reporting company under the Securities Exchange Act of 1934 to a nonreporting company and to reduce administrative expenses and costs of shareholder communications...” (the “Business Purpose”).

In analyzing the Bank’s proposal, the OCC found that Tennessee law permits share reclassification. The OCC noted that it has previously authorized national banks to use comparable governance procedures authorized by the laws of various states to: (1) divide a bank into two separate entities; (2) complete reverse stock splits; (3) effect share exchanges; and (4) issue blank check preferred stock.

The OCC found that permitting the share reclassification was consistent with its prior decisions. The OCC states in Letter #1125 that reorganizing by effecting a share reclassification and giving different types of consideration to shareholders in the exchange is not inconsistent with federal banking law and raises no safety and soundness concerns. The OCC further determined that the Bank was providing its shareholders with satisfactory dissenters’ rights and that the Bank’s Business Purpose was legitimate. Accordingly, the OCC concluded in Letter #1125 that the Bank, after filing an application with the OCC under 12 C.F.R. §5.46 and receiving the OCC’s conditional approval, may effect the proposed reclassification.

### **Exemptive Applications for ETFs that Rely Significantly on Derivatives on Hold While SEC Staff Reviews Derivative Use by Registered Funds**

The SEC staff is conducting a review of the use of derivatives by mutual funds, exchange-traded funds (“ETFs”) and other investment companies, which may result in

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changes to SEC rules and guidance in this area. Among the issues the staff has indicated it will explore are:

- how current market practices square with the leverage, concentration and diversification provisions of the Investment Company Act of 1940
- the risk management and other procedures followed by funds that rely substantially upon derivatives
- oversight of derivatives use by fund boards
- valuation and liquidity determinations for derivatives holdings
- prospectus risk disclosures regarding the risks of derivatives
- whether a fund's derivative activities should be subject to special reporting requirements

The staff is deferring consideration of requests from ETFs for exemptive relief that would allow them to make significant investments in derivatives until the review is complete. This decision affects new and pending requests from certain actively-managed and leveraged ETFs that particularly rely on swaps and other derivative instruments to achieve their investment objectives. The deferral does not affect any existing ETFs or other types of fund applications.