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DEVELOPMENTS OF NOTE

Federal District Court Dismisses with Leave to Amend Derivative Suit Based on Alleged Unlawfulness of Asset-Based Rule 12b-1 Payments by Mutual Fund Distributor to Selling Broker-Dealers

The U.S. District Court for the Northern District of California granted a motion to dismiss sought by a mutual fund distributor and the fund's independent trustees in a derivative suit brought by a fund shareholder alleging (a) a violation of Section 47(b) of the Investment Company Act of 1940, as amended (the "1940 Act"), by the distributor, and (b) state law claims of (i) breach of contract by the distributor, (ii) breach of fiduciary duty by the defendant trustees, and (iii) waste of fund assets by the defendant trustees. In summary, the plaintiff claimed that the fund's payment of asset-based compensation to broker-dealers under the fund's plan of distribution pursuant to Rule 12b-1 under the 1940 Act ("12b-1 fees") was unlawful under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), based on the ruling in *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) ("*Financial Planning*"), and that the trustees' malfeasance and/or failure to exercise adequate oversight in approving that compensation caused waste and injury to the fund and reduced shareholders' returns. The court's decision focused on the claim under Section 47(b), which provides that "[a] contract that is made, or whose performance involves, a violation of [the 1940 Act], or of any rule, regulation, or order thereunder, is unenforceable by either party . . . unless a court finds that under the circumstances enforcement would produce a more equitable result than nonenforcement and would not be

inconsistent with the purposes of [the 1940 Act].” As discussed in more detail below, the court concluded that the plaintiff had failed to state a claim under Section 47(b) because that section does not itself create a private right of action, but only provides a remedy if another section of the 1940 Act has been violated, and the plaintiff had not identified any violation of the 1940 Act.

DEMAND LETTER

Prior to commencing the suit, the plaintiff sent the trustees a letter demanding that the fund cease the payment of ongoing asset-based compensation to broker-dealers in connection with fund shares held in U.S. brokerage accounts and take all necessary and reasonable steps to restore to the fund all such past payments, on the grounds that the payments were improper for the reasons discussed above. The trustees responded that the plaintiff’s demands were not well founded and declined to follow the course of action proposed by the plaintiff. The plaintiff subsequently filed the claim on which the court ruled.

PLAINTIFF’S SECTION 47(B) CLAIM

The plaintiff asserted that pursuant to Rule 38a-1 under the 1940 Act (which is the compliance program rule for registered funds) a mutual fund’s board has a primary responsibility to prevent, detect and correct violations by a fund’s service providers of the federal securities laws, which include the 1940 Act and the Advisers Act, and that “the job of a mutual fund trustee is to actively police service providers (including the distributor/underwriter) for compliance with the federal securities laws,” which includes promptly voiding unlawful contractual commitments. The plaintiff further argued that because Section 47(b) provides that either party to a contract inconsistent with the requirements of the 1940 Act may request that a court void the contract, mutual fund trustees have an affirmative obligation to police compliance with the securities laws.

In the fund’s case, the plaintiff claimed that the asset-based compensation in the form of 12b-1 fees paid by the fund’s underwriter to broker-dealers resulted in a violation of the Advisers Act because broker-dealers may rely on the exception in Section 202(a)(11)(C) of the Advisers Act from the Act’s registration requirements only if they do not receive “special compensation” for providing investment advice. The plaintiffs asserted that because the 12b-1 fees paid by the fund’s distributor were asset-based rather than transaction-based, the broker-dealer recipients of those fees were receiving special compensation with respect to brokerage accounts in violation of the Advisers Act. The plaintiff pointed to the decision in *Financial Planning* as supporting this analysis. (In *Financial Planning*, the U.S. Court of Appeals for the D.C. Circuit (the “D.C. Circuit”) vacated a 2005 SEC rule that created additional exceptions from the definition of “investment adviser” under the Advisers Act for certain fee-based and discount brokerage programs. In finding that the SEC had exceeded its rulemaking authority, the D.C. Circuit devoted considerable attention to Section 202(a)(11)(C) of the Advisers Act, which excepts from the definition of “investment adviser” “any broker or dealer whose performance of [investment advisory services] is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor.” *Financial Planning* is discussed in detail in the [April 10, 2007 Alert](#).)

The plaintiff asserted that performance of the contracts between the fund’s distributor and broker-dealers involving the payment of asset-based compensation violated the 1940 Act because they authorized the use of fund assets to make “illegal payments” and in doing so

violated Rule 38a-1, which the plaintiff viewed as requiring that the fund and its service providers, and agents of those service providers, comply with all federal securities laws, including the Advisers Act. The plaintiff further alleged that “past unlawful payments” to the distributor and its agents constituted unjust enrichment that should be recovered by the fund.

THE COURT’S ANALYSIS

The court held that a claim under Section 47(b) must allege a violation of the 1940 Act; consequently, allegations of a violation of the Advisers Act could not serve as the basis of a Section 47(b) claim. The court found that the plaintiff had failed to allege any violation of the 1940 Act. In particular, the court found that the plaintiff had pled no facts identifying any defect in the fund’s Rule 38a-1 compliance policies and procedures. The court rejected the plaintiff’s expansive view of Rule 38a-1, stating that the Rule does not require a fund to assure that broker-dealers who receive 12b-1 fees comply with Advisers Act registration requirements; the duty under Rule 38a-1 is limited to adopting and implementing “compliance programs that are ‘reasonably designed to prevent violation of the Federal Securities Laws by the fund’” and provide for the oversight of compliance by the service providers specified in the rule, the fund’s investment adviser, principal underwriter, administrator, and transfer agent. The court also found that *Financial Planning* was irrelevant to the 12b-1 fees that were the focus of the plaintiff’s claim, noting that the fees at issue in *Financial Planning* were for investment advice, while the fund’s fees were paid for distribution. The court pointed out that the *Financial Planning* decision did not discuss 12b-1 fees, and that even if the decision applied to 12b-1 fees, it did not mean that the payment of such fees violated the Advisers Act, rather that the brokers receiving them would have to register as investment advisers under the Advisers Act.

DISPOSITION

Based on the foregoing, the court dismissed the plaintiff’s Section 47(b) claim with leave to amend and indicated that unless the plaintiff were able to state a claim under Section 47(b), the court would decline to exercise supplemental jurisdiction over the plaintiff’s other claims, which were made under state law. *Smith v. Franklin/Templeton Distributors*, No. C 09-4775 PJH (N.D. Cal., June 8, 2010)

Goodwin Procter LLP represented the independent trustees in this proceeding.

Federal Banking Agencies Release Interagency Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions

The OCC, FRB, FDIC, NCUA and OTS (the “Agencies”) jointly issued guidance (the “[Guidance](#)”) addressing supervisory considerations related to bargain purchase gains and the impact such gains have on the application approval process. The Guidance clarifies that all business combinations, including bargain purchase transactions and assisted transactions, should be accounted for in accordance with Accounting Standards Codification (“ASC”) Topic 805. With limited exceptions, ASC Topic 805 requires all recognized assets acquired and liabilities assumed in a business combination to be measured at their acquisition-date fair values in accordance with ASC Topic 820.

The Guidance notes that an acquiring institution's regulatory capital is subject to retrospective adjustments made during the "measurement period" – the period of time after the acquisition date that is required to identify and measure the fair value of the assets acquired and liabilities assumed in a business combination. Because of this uncertainty, an acquiring institution's primary federal regulator will review the significance of any gain expected to be recognized from a bargain purchase (for example, relative to the pro forma capital structure of the acquiring institution) when evaluating an application in connection with a business combination. To facilitate this review of the pro forma capital calculations, an acquiring institution is encouraged by the Agencies to include one pro forma balance sheet with two sets of pro forma capital calculations in any application requesting approval of a business combination that results in a bargain purchase. The first set of pro forma capital calculations should include a preliminary estimate of the gain from a bargain purchase, and the second set should eliminate that gain.

The Agencies may impose any of the following conditions in their approvals of business combinations where a bargain purchase gain is contemplated:

- *Capital Preservation* – An acquiring institution may be required to hold capital in excess of regulatory minimums in an amount commensurate with its asset quality and overall risk profile.
- *Dividend Limitations* – An acquiring institution may be required to exclude the bargain purchase from its dividend-paying capacity calculation until the end of the conditional period.
- *Independent Audits* – An acquiring institution, if not subject to an annual audit requirement, may be required to obtain an independent audit of its financial statements for the year in which a business combination occurs (and the subsequent year, if the measurement period is expected to continue into that year).
- *Independent Valuations* – An acquiring institution may be required to obtain independent valuations from a reputable and experienced third party valuation expert deemed acceptable to the agency for some or all of the identifiable assets acquired and liabilities assumed.
- *Legal Lending Limit* – An acquiring institution may be required to exclude any bargain purchase gain from the calculation of its legal lending limit until the end of the conditional period.

The Guidance does not add to or modify existing regulatory reporting requirements issued by the Agencies or current accounting requirements under GAAP.

FDIC Issues Guidance on Deposit Placement and Collection Activities

The FDIC issued guidance (FIL-29-2010) (the "[Guidance](#)") for depository institutions and others involved in deposit placement and collection activities. In the Guidance, the FDIC outlines steps to be taken by insured depository institutions to ensure that depositors are appropriately notified regarding (a) whether their deposits are insured and (b) the steps that institutions and affiliates should take to ensure that deposits qualify for "pass-through" insurance. Citing existing insurance rules, the FDIC notes that to receive pass-through insurance, (1) the institution's records must expressly disclose the fiduciary relationship on

behalf of others, (2) the records maintained by either the institution, the fiduciary, or an authorized third party must identify the actual owner or owners of the funds in the account and their respective ownership interests in the account, and (3) the funds must be owned by the customer(s) and not the entity performing in a fiduciary capacity.

For institutions that accept deposits with the intent to place some or all of the deposits with other institutions, the Guidance notes that depository institutions or their affiliates should:

- Maintain sufficient documentation for pass-through insurance coverage and a detailed listing of the name and location of receiving institutions, the owner of the funds, and the amount, interest rate, and maturity date of the deposits.
- Provide the depositors with the deposit amount and the name of the receiving insured depository institution at which their deposits are ultimately placed.
- Ensure the accuracy of marketing materials, customer statements, and disclosures regarding FDIC deposit insurance coverage on the accounts.
- Provide training for all personnel involved in collecting and placing deposits.
- Ensure deposit collection and placement activities comply with applicable consumer protection laws, regulations, and supervisory guidance.

The FDIC also states that deposits accepted from agents or custodians generally are considered brokered deposits, the receipt of which requires a waiver from the FDIC for an adequately capitalized institution and is prohibited for an undercapitalized institution.

Congressional Budget Office Issues Report Concerning Financial Impact of FRB Actions Taken During the Financial Crisis

The Congressional Budget Office (the “CBO”) issued a report entitled *The Budgeting Impact and Subsidy Costs of the Federal Reserve’s Actions During the Financial Crisis* (the “[Report](#)”). The Report describes the various actions taken by the FRB to stabilize the financial markets during the recent financial crisis and analyzes how these FRB actions are likely to affect the federal budget in the future. The Report also estimates the “risk-adjusted (or fair value) subsidies that the [FRB] provided to financial institutions through [the FRB’s] emergency programs.” In summarizing the actions taken by the FRB to stabilize the financial markets during the financial crisis, the Report specifically reviews the FRB’s: (1) expanded lending to depository institutions; (2) creation of new lending facilities for nondepository financial institutions; (3) purchases of mortgage-related securities and medium- and long-term length U.S. treasuries in the open market; and (4) support of financial institutions whose potential failure posed a systemic risk. The CBO concluded in the Report that the approximately \$21 billion of subsidies provided by the FRB to support financial institutions during the financial crisis provided benefits to the financial system that exceeded its costs. Furthermore, had the FRB not taken these actions, the Report states, the financial crisis would have in all likelihood been more protracted and the broader economy would have been more extensively damaged.

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SEC Approves Stock-by-Stock Circuit Breaker Rules

The SEC issued an [order](#) approving rule proposals by U.S. securities exchanges and an [order](#) approving a rule proposal by FINRA that would establish a pilot program under which trading in any stock in the S&P 500® Index would pause across U.S. equity markets for a five-minute period in the event that the stock experiences a 10% change in price over the preceding five minutes. The SEC indicated in its [announcement](#) regarding the approvals that the exchanges and FINRA were expected to begin implementing the new rules as early as June 11. The pilot will continue through December 10, 2010. The SEC also indicated that it anticipated the exchanges and FINRA would file additional rule proposals in the near future to expand the scope of the pilot (for example, to include ETFs) within the pilot period. At the request of SEC Chairman Mary Schapiro, the SEC staff also will:

- consider ways to address the risks of market orders and their potential to contribute to sudden price moves.
- consider steps to deter or prohibit the use by market makers of “stub” quotes, which are not intended to indicate actual trading interest.
- study the impact of other trading protocols at the exchanges, including the use of trading pauses and self-help rules.
- continue to work with the exchanges and FINRA to improve the process for breaking erroneous trades, by assuring speed and consistency across markets.

The SEC staff will also consider whether to recalibrate the existing market-wide circuit breakers for equity trading venues and futures markets, which were not triggered on May 6.

OTHER ITEM OF NOTE

SEC to Consider Rulemaking Addressing Target Date Retirement Fund Names and Advertising at June 16 Open Meeting

At its open meeting on June 16, 2010, the SEC is scheduled to consider whether to propose amendments to Rules 156 and 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act of 1940 to address concerns about target date retirement fund names and marketing materials.