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DEVELOPMENTS OF NOTE

President Obama Signs Federal Credit Card Legislation

On May 22, 2009, President Obama signed into law the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the "Act"). The Act significantly changes requirements applicable to credit card and gift card issuers. Included among the Act's many new requirements are a 45-day advance notice requirement for an increase in the annual percentage rate ("APR") or for other changes in terms to a credit card agreement that are "significant," as determined by the FRB; a requirement to review accounts that have been subject to an APR increase every 6 months to determine whether the APR should be decreased; a restriction on the ability of creditors to increase an APR, fee or finance charge during the first year an account is open; and a prohibition on double-cycle billing. The Act also restricts the charging of certain fees on general-use prepaid card, gift certificate and store gift card accounts. The majority of the Act's requirements go into effect in February 2010. Some of the Act's requirements, however, including the 45-day advance notice requirement, go into effect on August 20, 2009, while others go into effect in August 2010. For a detailed discussion of the Act prepared by our Consumer Financial Services Practice area please see the June 2, 2009 issue of our sister publication, the *Consumer Financial Services Alert*.

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SEC Settles Enforcement Action against Mutual Fund Investment Adviser Relating to Disclosure Regarding Fund Guarantee Feature Made to Fund Board during Advisory Contract Approval Process and in SEC Filings

The SEC settled an administrative enforcement proceeding against an investment adviser to a registered investment company relating to the fund's "Section 15(c) process," as well as disclosure in various SEC filings. Section 15(c) of the Investment Company Act of 1940 (the "1940 Act") generally requires that a majority of a fund's disinterested directors annually approve the advisory contract between the fund and the fund's investment adviser, and in connection with that approval, the investment adviser is required to furnish to the fund's board such information "as may reasonably be necessary [for the board] to evaluate the terms" of that contract. According to the administrative order issued in connection with the settlement (the "Order"), the adviser, through an affiliate, had offered a guarantee (the "Guarantee") protecting an investor's principal invested in the fund, provided that the investor continuously maintained his or her investment in the fund for a ten-year period. Also according to the Order, the fund's prospectus had stated that the Guarantee was being provided without any cost to the fund or its shareholders.

The Order states three principal findings made by the SEC:

- The adviser violated Section 15(c) by failing to provide to the board adequate information in order that it could evaluate the cost of the Guarantee in the context of the management fee that the adviser was charging. In particular, the SEC found that for several years during the Section 15(c) process, the adviser had justified its management fees – fees that allegedly were substantially higher than the market average for that type of fund – by pointing to the fact that an affiliate was providing the Guarantee; however, the adviser failed to provide the board with (a) information necessary to evaluate the true cost or value of the Guarantee, (b) the assumptions used to calculate loss reserves related to the Guarantee, or (c) an explanation describing why the reserve should be included in an analysis of the profitability of the fund.

- The adviser violated Section 206(2) of the Investment Advisers Act of 1940, which generally prohibits an investment adviser from engaging in any transaction, practice or course of business that operates as fraud or deceit on any client or prospective client, for reasons substantially similar to the reasons the SEC gave for the Section 15(c) violations.

- The adviser violated Section 34(b) of the 1940 Act for stating in the fund's annual reports to shareholders, registration statements and prospectuses filed with the SEC that the Guarantee was being provided without cost to the fund or its shareholders even thought the adviser was using the cost of the Guarantee to justify its higher fees to the fund's board. Section 34(b) generally prohibits any person from making an untrue statement of material fact in registration statements and other documents filed with the SEC, or omitting to state a fact necessary to make the statements made from being materially misleading.

Under the terms of the settlement, the adviser agreed, among other things, to pay disgorgement of approximately $4 million (the amount by which the SEC found the management fees the fund paid the adviser during the relevant period exceeded the "peer median") and a civil penalty of $800,000.

FRB Outlines TARP Repayment Criteria

The FRB outlined the criteria it will use to evaluate applications to redeem preferred shares issued to the Treasury under the Capital Purchase Program or the Targeted Investment Program ("Treasury Capital") from the 19 bank holding companies ("BHCs") that participated in the Supervisory Capital Assessment Program ("SCAP"). Please see the April 28, 2009 *Alert* and the February 25, 2009 *Alert Special Edition* for a further discussion of the SCAP.

Redemption approvals for an initial set of these large BHCs are expected to be announced during the week of June 8, 2009. Applications will be evaluated periodically thereafter. Any banking organization wishing to redeem Treasury Capital must first obtain approval from its primary federal supervisor, which will then forward approved applications to the Treasury. Any BHC seeking to redeem Treasury Capital must demonstrate an ability to access the long-term debt markets without reliance on the FDIC's Temporary Liquidity Guarantee Program ("TLGP"), and must successfully demonstrate access to public equity markets.

In addition, the FRB's review of a BHC's application to redeem Treasury Capital will include consideration of the following:

- Whether a BHC can redeem its Treasury Capital and remain in a position to continue to fulfill its role as an intermediary that facilitates lending to creditworthy households and businesses;
- Whether, after redeeming its Treasury Capital, a BHC will be able to maintain capital levels that are consistent with supervisory expectations;
- Whether a BHC will be able to continue to serve as a source of financial and managerial strength and support to its subsidiary bank(s) after the redemption; and
- Whether a BHC and its bank subsidiaries will be able to meet its ongoing funding requirements and its obligations to counterparties while reducing reliance on government capital and the TLGP.

Finally, all of the 19 BHCs are required to have a robust longer-term capital assessment and management process geared toward achieving and maintaining a prudent level and composition of capital commensurate with the BHC's business activities and firm-wide risk profile.

FDIC Adopts Final Rule Concerning Interest Rate Restrictions on Institutions that are Less than Well-Capitalized

The FDIC adopted a final rule (the "Final Rule") that makes certain revisions to the interest rate restrictions in the FDIC's regulations regarding brokered deposits to provide greater flexibility to institutions that are not well-capitalized. The FDIC stated that the Final Rule addresses concerns caused by the fact that the U.S. Treasury bond-yield benchmark for brokered deposits of such institutions under the current rule has been volatile and is currently abnormally low, making it difficult for the institutions to attract brokered deposits due to compressed limits on permissible brokered deposit rates.

Under existing Part 337.6 of the FDIC's regulations, a bank or thrift that is less than well-capitalized may not pay an interest rate that significantly exceeds the prevailing rate in the institution's market area or the market area in which the deposit is accepted. For out-of-area brokered deposits the rate to be followed is the "national rate," which is currently defined as 120 percent of the current yield on similar maturity U.S. Treasury obligations.

The Final Rule, which is substantially similar to the FDIC's proposed version (discussed in the February 3, 2009 *Alert*), redefines the "national rate" for purposes of the Final Rule to be "a simple average of rates paid by all depository institution and branches for which data are available." In other words, the prevailing rate in all market areas for deposits of similar size and maturity under the Final Rule will be the "national rate." The FDIC stated that this approach in the Final Rule reflects increased national competition for deposits because of the increase in Internet deposits and Internet advertising of deposit rates.

As an alternative, the FDIC also will permit an institution that believes the prevailing rates in its area exceed the national average to redefine its market area, provided, however, that the institution must overcome a rebuttable presumption that the national rate should be used by providing support to the FDIC of the existence of such higher local rates. The FDIC said that it would issue written guidance on the process that a financial institution should use to support its proposed usage of a local rate.

To provide institutions with the rate information to comply with the Final Rule, the FDIC will publish a schedule of "national rates" by maturity. The rate caps for such deposits, will be the national rate plus 75 basis points. The FDIC said that it will post separate rates and rate caps for: (1) NOW accounts; (2) Money Market Deposit Accounts (MMDAs); and (3) savings accounts (other than MMDAs). The Proposed Rule will be effective on January 1, 2010.

SEC Settles Administrative Proceedings with former President and former General Counsel of Third Party Mutual Fund Administrator over Undisclosed Marketing Arrangements with Mutual Fund Adviser

The SEC issued orders settling administrative proceedings against the former president of a third party mutual fund administrator (the "Administrator") and the former general counsel of the Administrator over an undisclosed marketing arrangement between the Administrator and the investment adviser (the "Adviser") of a family of mutual funds (the "Funds"). The former president also served as chairman of the board of trustees of the Funds. This article describes the SEC's findings as presented in the orders with respect to the former president and former general counsel and in a prior order with respect to the Administrator relating to the same subject matter; in each case, the party to the order consented to the order without admitting or denying its findings.

Prior Proceedings Against the Administrator. In 2006, the SEC issued an order (the "2006 Order") settling administrative proceedings against the Administrator based on findings that, between June 1999 and July 2004, rebates of mutual fund administrative fees paid by the Administrator to the advisers of funds that the Administrator serviced resulted in violations of the Advisers Act of 1940, as amended (the "Advisers Act"), and the Investment Company Act of 1940, as amended (the "1940 Act"). As found in the 2006 order, the Administrator entered into oral and written side agreements ("Side Agreements") with 27 mutual fund advisers under which the advisers recommended to mutual fund boards that the Administrator be retained as fund administrator. The Administrator paid rebates to

the fund advisers under the Side Agreements with amounts set aside by the Administrator from the fees it received under the fund administration agreements. The rebated amounts were designated as a marketing budget for the advisers to use in promoting fund sales; in some cases, an adviser also used its marketing budget to pay expenses entirely unrelated to fund marketing, including check fraud losses, seed capital for new mutual funds, and expenses for settlement of adviser disputes with third parties.

The existence and terms of the Side Agreements were not disclosed to the mutual funds' boards or shareholders although fund boards were generally informed that the Administrator spent a portion of its administration fee on marketing the mutual funds. Fund boards were not informed that the Administrator and the respective advisers had entered into Side Agreements before the advisers recommended to the fund directors that the Administrator be awarded the administration agreements to which the Side Agreements related. The marketing arrangements contemplated by the Side Agreements were not included in any of the funds' Rule 12b-1 plans. There was no disclosure to shareholders of the marketing arrangements until the fall of 2003, and the SEC found that those disclosures were incomplete and misleading. From July 1999 to June 2004, the Administrator provided over $230 million from its administration fees for the benefit of the funds' advisers or third parties pursuant to the Side Agreements.

The Administrator was found to have willfully aided and abetted and caused (a) the advisers' violations of Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser, and Section 34(b) of the 1940 Act, which prohibits the making of any untrue statement of a material fact in a mutual fund registration statement, and (b) the mutual funds' violations of Section 12(b) of the 1940 Act and Rule 12b-1(d) thereunder, which provides that any person who is a party to any agreement with a mutual fund relating to the fund's Rule 12b-1 plan has a duty to furnish such information as may reasonably be necessary for the fund's directors to make an informed decision regarding whether the Rule 12b-1 should be implemented or continued.

Prior Proceedings against the Adviser. In 2008, the SEC settled administrative proceedings against the Adviser regarding Side Agreements between it and the Administrator relating to the Funds and similar rebate arrangements relating to securities lending services provided by the Administrator to the Funds. Consistent with the 2006 Order, the SEC found that the Adviser had willfully violated Sections 206(1) and 206(2) of the Advisers Act, willfully violated Section 34(b) of the 1940 Act and willfully aided and abetted and caused violations of Section 12(b) of the 1940 Act and Rule 12b-1 thereunder by the Adviser's funds. The SEC has not announced any action taken against any of the other unnamed advisers referenced in the 2006 Order.

Findings – Former General Counsel. Prior to the first of the two Side Agreements between the Administrator and the Adviser, the former general counsel retained outside counsel to provide legal advice regarding marketing arrangements. Outside counsel provided a written memorandum that analyzed, among other distribution-related issues, marketing arrangements in which the Administrator would agree to pay a fixed amount of its fee to market mutual funds it serviced. The memorandum stated that when the Administrator agrees to pay a fixed amount of its fee to market a mutual fund it has a duty to disclose the existence of the arrangement to a fund's trustee, and the fund's statement of additional information should include disclosure regarding the arrangement. The former general counsel did not disclose the Side Agreements' marketing arrangement to the Funds' board of trustees or to their shareholders even though she received, reviewed, and commented on

drafts of the Side Agreements. The SEC noted that the former general counsel had indicated on drafts of the Side Agreements that there were issues with the arrangement under Rule 12b-1.

Subsequent to entering into Side Agreements, the former general counsel reviewed and commented on a disclosure template for the Funds' trustees addressing the marketing assistance provided by the Administrator. The template described the arrangement as an "informal arrangement under which [the Administrator] voluntarily expends its own assets in marketing the Funds." The SEC found this disclosure to be misleading because it failed to describe the exchange of a portion of the administration fee for a recommendation to the Funds' board or disclose the fact that the Administrator's expenditures were not voluntary, but had been negotiated and agreed upon by the parties. Subsequently, the former general counsel drafted a disclosure template for inclusion in the Funds' statements of additional information ("SAIs") concerning the marketing arrangements that indicated that the Funds' distributor, an affiliate of the Administrator, could finance from its own resources certain activities intended to result in the distribution of the Funds' shares. The SEC found that the template, which served as the basis for the disclosure eventually included in the Funds' SAIs, was misleading because it, among other things, failed to describe the nature of the arrangement in which the Administrator contractually agreed to set aside a certain portion of its administration fee to be used at the Adviser's direction in exchange for the Adviser's recommending the Administrator as administrator to the Funds' board.

Findings – the Former President. Prior to the entering into a Side Agreement with the Adviser, the former president, who also served as chairman of the Funds' board of trustees, received a legal memorandum from outside counsel recommending that the Administrator disclose marketing arrangements of the type embodied in the Side Agreement to Fund shareholders and trustees. Subsequent to executing the Side Agreement, the former president executed administration and sub-administration agreements between the Administrator and Funds without disclosing either the existence of the Side Agreement or its terms to the Funds' boards of trustees or shareholders. Prior to the execution of the second Side Agreement, the former president was copied on an e-mail from one of the Funds' independent trustees requesting a breakdown of the fees for administration and other contract proposals relating to the Administrator being considered for approval by the Funds' board at the time. The former president did not apprise the independent trustee of the rebate arrangements under the proposed Side Agreement. Subsequently while presiding over a meeting at which the renewal of the Funds' agreements with the Administrator was discussed, the former president failed to disclose terms of the Side Agreement then in process.

Violations. The SEC found that the former general counsel and former president each had willfully aided and abetted and caused the Adviser's violations of Sections 206(1) and 206(2) of the Advisers Act.

Sanctions. As part of her settlement, the former general counsel agreed to pay a total of approximately $21,000 in disgorgement and prejudgment interest and a civil money penalty of $15,000. As part of his settlement, the former president agreed to pay a total of $18,000 in disgorgement and prejudgment interest.

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OCC Issues Interpretive Letter Regarding Purchase of Auction Rate Preferred Securities

The OCC issued Interpretive Letter #1115 ("Letter #1115"), permitting the purchase of auction rate preferred securities (the "Securities") by a wholly-owned subsidiary (the "Subsidiary") of a national bank (the "Bank"). The Securities pay a fixed yield or a specified yield based on a rate or index not under the control of the issuer or the purchaser. The Securities are perpetual, but may be redeemed at the option of the issuer and contain mandatory redemption provisions that require the issuer to redeem the Securities at par plus accumulated dividends under certain conditions. The Securities rank senior to the issuer's common stock and the dividends are cumulative.

Letter #1115 reiterates that a national bank may purchase for its own account investment securities under such limitations and restrictions as the OCC may prescribe. The OCC defines an "investment security" as a marketable debt obligation that is not predominantly speculative in nature. Letter #1115 states that preferred stock is a hybrid instrument that can be structured to resemble either a debt instrument or common stock and notes that OCC precedent recognizes that national banks may purchase preferred stock as an investment security when the characteristics of the instruments are predominately debt-like. In Letter #1115 the OCC concludes that the Securities qualify as investment securities because they possess characteristics commonly associated with debt instruments: fixed yields, priority over equity shareholders in the case of issuer default, and cumulative dividends.

In this regard, though the Securities are perpetual, the OCC has recognized that a perpetual preferred stock may qualify as an investment security. Because the Bank's holding company (the "Holding Company") agreed to purchase the Securities after a three year period of time, the OCC determined that the Subsidiary has effectively limited the duration of its investment. Further, the OCC determined that the Securities' optional and mandatory redemption provisions potentially limit the Securities' term. The Securities have limited rights to vote for at least two directors at a time. As a condition of the OCC finding that the Securities are a permissible investment security, the Bank agreed to limit the Subsidiary's exercise of voting rights. The Bank and the Subsidiary also entered into an agreement with the OCC that requires the Bank and the Subsidiary to enter into an indemnification agreement with the Holding Company whereby the Holding Company will cover certain losses should they occur and the Holding Company will repurchase any of the Securities that become low-quality assets.