

Financial Services Alert Quarterly

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Developments of Note

➤ **California Attorney General and Fund Family's Adviser and Distributor Agree to End Litigation Related to Revenue Sharing**

The California Attorney General announced that it had reached an agreement to end litigation between the state and the distributor for a family of mutual funds and the affiliated adviser to the fund family over revenue sharing arrangements with broker-dealers selling the funds' shares (the distributor and adviser being collectively referred to as the "Sponsor"). The Attorney General had filed suit against the Sponsor alleging that the failure to accurately disclose directed brokerage and revenue sharing arrangements with selling broker-dealers in the funds' prospectuses violated antifraud provisions of the California Corporate Securities Law. (In general terms, revenue sharing involves payments by a fund's adviser and/or distributor to a broker-dealer that sells the fund's shares as compensation for the broker-dealer's efforts on the fund's behalf, while directed brokerage, now prohibited under the Investment Company Act of 1940, as amended, and FINRA rules, involves an adviser's directing fund portfolio transactions to a selling broker-dealer for the same purpose.) For its part, the Sponsor had filed suit against the Attorney General seeking (a) a declaratory judgment that the funds' prospectus disclosures regarding directed brokerage and revenue sharing practices were accurate and not misleading under federal and state law and (b) an injunction enjoining the Attorney General from commencing or maintaining any enforcement action against the Sponsor on the grounds that any such action was preempted by the National Securities Market Improvement Act of 1996 ("NSMIA").

In 2007, the California Court of Appeal for the Second Appellate District, in a reversal of a trial court decision, held that NSMIA did not preempt the Attorney General's suit (as discussed in the February 6,

2007 *Alert*). Subsequently, the California Court of Appeal for the Third Appellate District expressed a similar view regarding NSMIA preemption when it reversed a trial court's dismissal of an action brought by the Attorney General against a brokerage firm for failure to adequately disclose to investors and potential investors certain revenue sharing arrangements under which the brokerage firm received additional compensation for its sales efforts on behalf of certain preferred mutual fund families (as discussed in the September 18, 2007 *Alert*).

The terms of the Agreement of Discontinuance (the "Agreement") between the Attorney General and the Sponsor include payment by the Sponsor of \$2.5 million representing the costs and attorneys' fees incurred by the Attorney General in the lawsuits and investigation. The Attorney General's press release announcing the Agreement cited positive changes in the mutual fund industry as a result of regulatory and enforcement action and noted that voluntary measures undertaken by the Sponsor in its sales practices and other areas affecting the fund family had resolved the state's concerns. The Agreement noted the following changes in the Sponsor's sales practices:

- eliminating the use of correspondent/clearing arrangements in recognition of mutual fund sales and discontinuing the practice of directed brokerage prior to the SEC's adoption of a rule banning the practice
- commencing efforts to enhance expense disclosures provided to retirement plan participants
- committing to enhance fund prospectus disclosure regarding revenue sharing practices
- developing and implementing a policy to guide and enhance the supervision and oversight of dealer relationship managers' revenue-sharing activities
- establishing a distribution oversight committee comprised of several of the fund family's independent directors that meets at least annually to discuss relevant distribution-related issues affecting the fund industry and the fund family, and with participation from the distributor's senior management, to review the distributor's significant business initiatives and financial results

The Agreement also notes the Attorney General's consideration of the Sponsor's efforts and undertakings in the area of fund expenses, as follows:

- the management, Rule 12b-1 and other fees charged to the fund family's shareholders are in aggregate among the lowest in the industry
- in 2005, the funds' adviser began waiving 10 percent of its management fees, resulting in aggregate savings to fund shareholders to date of approximately \$1 billion
- the Sponsor will, at its own expense, proactively encourage the fund family's shareholders to opt out of receiving paper disclosure documents in favor of receiving those documents electronically, at a potential savings of up to \$20 million (the Agreement also provides that, to the extent disclosure documents are printed in the future, they will be printed on recycled paper using soy or other vegetable-based ink)

The Agreement cited the following measures undertaken by the Sponsor regarding director and shareholder education:

- at its own expense and on a regular basis the Sponsor conducts seminars for the fund family's independent directors that include sessions designed to assist them in carrying out their governance duties
- the Sponsor has developed the fund family's website at its own expense with current expenditures amounting to over \$42 million per year
- the Sponsor provides other services and information to shareholders, including: publishing shareholders' newsletters (\$10 million), underwriting wholesalers' meetings with shareholders to educate them about basic investment concepts and how those concepts relate to the fund family

(\$20-30 million), and directly providing or assisting intermediaries in providing shareholder services (\$40 million)

➤ **Federal Circuit Overturns OCC Penalty against Outside Auditor of Failed Bank**

The United States Court of Appeals for the District of Columbia Circuit (the “Federal Circuit”) overturned a \$300,000 civil money penalty and an enforcement order by the OCC against Grant Thornton LLP in connection with Grant Thornton’s audit of the mortgage operations of First National Bank of Keystone (“Keystone” or “Bank”), a bank that subsequently failed as a result, in whole or in part, of fraudulent acts by certain of the Bank’s senior managers.

Grant Thornton was retained by Keystone, pursuant to an OCC enforcement action against the Bank, to audit Keystone’s mortgage operations, “assess the accuracy of its financial statements, and determine the validity of [Keystone’s] accounting for loans it purchased and bundled into securities.” Following Grant Thornton’s audit of the Bank, and its issuance of an audit opinion stating that the Bank’s financial statements were free of material misstatement, OCC examiners uncovered evidence that Keystone fraudulently inflated its interest income and assets to mask the fact that the Bank had been insolvent. The OCC, citing its authority pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”), imposed the penalty on Grant Thornton asserting that Grant Thornton participated in an unsafe or unsound banking practice by recklessly failing to comply with Generally Accepted Auditing Standards (“GAAS”) in planning and conducting its audit of Keystone.

The Federal Circuit vacated the penalty and order on the finding that in performing its audit Grant Thornton was not “engaged” or “participating in” the conduct of the business of the Bank. The Federal Circuit held that Grant Thornton did not participate in an “unsafe or unsound [banking] practice” because an external audit of the type conducted by the firm is not a “banking practice” as defined by FIRREA. The Federal Circuit further noted that it would “not attempt to define the full universe of activities that encompass ‘banking practices,’” but asserted with certainty that “an external auditor whose sole role is to verify a bank’s books cannot be said to be engaging in a ‘banking practice.’”

A concurring opinion rejected the majority’s reasoning and argued that the scope of Grant Thornton’s work was broad enough to be covered as a banking practice by FIRREA. However, the concurring opinion asserted that FIRREA does not provide authority to impose firm-wide penalties unless many or most of the firm’s managing partners or senior officers of the entity have engaged in the wrongful conduct.

➤ **SEC Votes to Propose Amendments to Form ADV Part II and to Require Electronic Filing**

At its open meeting on Wednesday, February 13, the SEC voted to propose amendments to the content and presentation requirements of Part II of Form ADV, the registration form for advisers registered with the SEC under the Investment Advisers Act of 1940, as amended. The proposal would also require registered advisers to file Part II electronically with the SEC, which would make the filings publicly available on its website. In 2000, the SEC proposed amendments to both Parts I and II of Form ADV, and proposed that Form ADV be filed electronically, but adopted amendments and the electronic filing requirement only with respect to Part I.

The proposed amendments, if adopted, will eliminate the current check-the-box format of Form ADV and will instead require a registered adviser to provide clients with a narrative brochure containing plain English descriptions of the adviser’s business practices, services, and conflicts of interest. Charts, graphs and glossy pictures would be permitted in the brochure, which could be filed in pdf format with the SEC and delivered electronically to clients. Aside from annual amendments, updates would only be required for disciplinary history changes. (Currently, Form ADV Part II must be updated to reflect changes in the responses to a number of the Form’s items.)

The brochure would have to contain expanded soft dollar disclosure, making clear to clients that (1) the adviser would otherwise have to pay for soft dollar benefits out of its own resources, (2) soft dollars

create an incentive to direct brokerage and (3) the client may pay more for brokerage due to the adviser's use of soft dollars. Advisers would also have to specify in the brochure the types of products and services they received in exchange for soft dollars. The proposal would mandate additional discussion of the conflicts of interest created for an adviser that manages accounts with performance fees at the same time as accounts without them. The SEC's proposal would require an adviser's brochure to disclose any receipt of compensation, such as sales awards from non-clients, that created incentives to recommend particular products. The proposal would also require a brochure supplement containing key information on advisory personnel, including education, disciplinary history, and non-advisory business activities.

Comments on the proposed amendments will be due no later than 60 days after a formal proposing release is published in the *Federal Register*. The description of the proposed amendments in this article is based on the SEC press release announcing them and remarks made at the open meeting. The *Alert* will provide more detailed coverage once the formal release is posted on the SEC website.

➤ **Federal Appeals Court Holds that HOLA Preempts California UCL Claims over Lock-In Fees**

The U.S. Court of Appeals for the Ninth Circuit (the "Ninth Circuit") ruled that the Home Owners' Loan Act ("HOLA") preempts California state law claims challenging lock-in fees. Plaintiffs paid the lender a \$400 lock-in fee at application, but then rescinded the loan within 3 days under the Truth in Lending Act. Plaintiffs brought a class action lawsuit, claiming that the lender violated TILA by not returning the lock-in fee in response to the rescission. Plaintiffs did not sue under TILA, however, instead bringing their claims under California's Unfair Competition Law (the "UCL"), alleging that the lock-in policy was unlawful, unfair and deceptive under the various prongs of the UCL.

In affirming the district court, the Ninth Circuit ruled that the OTS's broad field preemption regulations, promulgated under HOLA's authority, preempted plaintiffs' lawsuit. The Ninth Circuit found the UCL provisions at issue, as applied to Plaintiffs' claims, were all within the scope of the regulation's list of specifically preempted state laws. The Ninth Circuit followed the OTS methodology for preemption analysis – finding that because the laws were within the scope of the list of state laws preempted, there was no need to even consider whether the field preemption "incidental affects" exceptions applied. *Silvas v. E*Trade Mortgage Corp.*, No. 06-55556 (9th Cir., Jan. 30, 2008).

➤ **SEC Cites Investment Management Priorities in Congressional Justification for 2009 Budget**

The SEC's Congressional Justification for its fiscal 2009 budget discussed the Division of Investment Management's strategic priorities for fiscal 2008 and 2009. (An agency's Congressional Justification, which is submitted in conjunction with the President's budget request, details the agency's recent accomplishments, how it spent past appropriations, and how it intends to use the requested funds.) The Congressional Justification identifies the Division's top strategic priority for 2008 and 2009 as recommending that the Commission adopt and implement the recent proposal to revise mutual fund prospectus disclosure requirements and replace the profile with the summary prospectus. (This proposal was the subject of a Client Alert available at <http://www.goodwinprocter.com/~media/AEF906C8F8A74A778EA9C7E7D8E2A0FC.ashx>.) The Division also anticipates recommending that the Commission propose in FY 2008 and adopt in FY 2009 a rule that would reform or rescind Rule 12b-1 under the Investment Company Act of 1940, as amended. Rule 12b-1 governs the use of a mutual fund's assets to pay for distribution-related activities. The Congressional Justification also identifies the promotion of interactive data tagging in fund disclosure documents and financial reports as an ongoing priority.

➤ **SEC Proposes Disclosure Requirements for Divestment by Registered Investment Companies under the Sudan Accountability and Divestment Act of 2007**

The SEC proposed amendments to Forms N-CSR and N-SAR that would enable a registered investment company to rely on protections provided under the Sudan Accountability and Divestment Act of 2007 (the “Sudan Divestment Act”) when it divests from securities of issuers that it determines conduct or have direct investments in certain business operations in Sudan (“Sudan-Related Issuers”). The Sudan Divestment Act limits civil, criminal, and administrative actions that may be brought against a registered investment company that divests itself of securities of Sudan-Related Issuers, provided that the investment company makes disclosures in accordance with SEC rules.

Under the SEC’s proposal, disclosure of a divestment would have to be included in the next report on Form N-CSR for mutual funds and other management investment companies, and on Form N-SAR for unit investment trusts. Form N-CSR is used to file shareholder reports and related certifications with the SEC, while semi-annual Form N-SAR filings provide the SEC with information on specified topics primarily related to a registered investment company’s financial statements; both forms are filed electronically and made publicly available on the SEC’s website.

A registered investment company would also have to disclose certain information if it continues to hold any securities of an issuer whose securities are reflected in a Form N-CSR/N-SAR divestment disclosure. The SEC’s proposal would not require a registered investment company to disclose divestments of securities of Sudan-Related Issuers; however, a registered investment company that did not disclose a divestment would not benefit from the protections of the Sudan Divestment Act. Comments on the SEC’s proposal must be submitted on or before March 17, 2008.

Other Items of Note

➤ **Goodwin Procter Makes Recording Available of its Webinar Concerning the Rise of ERISA Litigation Involving Collective Trusts and Other Retirement Products**

As discussed in prior issues of the *Alert*, on February 7th Goodwin Procter hosted a webinar on current trends in capital market ERISA litigation and related regulatory investigations involving ERISA-governed retirement plans and managers of plan assets.

The webinar addressed the recent wave of ERISA litigation and related regulatory investigations - - including matters involving collective trusts, so-called excessive fees, and “stock drops.” Goodwin Procter litigators also shared their views on current trends in this area and discussed steps that may be taken by financial services firms now to prevent, or at least defend against, such regulatory investigations and litigation.

To hear a recorded version of the webinar, or download the presentation pdf, please click below.

[The Rise of ERISA Litigation Involving Collective Trusts and Other Retirement Products](#)

**Goodwin Procter LLP
Financial Services
Partners and Counsel**

Lynne B. Barr
Gary A. Beller
Kay E. Bondehagen
Raymond P. Boulanger
Agnes Bundy Scanlan
Margaret B. Crockett
Anna E. Dodson
Eric R. Fischer
Elizabeth Shea Fries
Jackson B.R. Galloway
James J. Kelly
Satish M. Kini
William R. Kirschner
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Paul W. Lee
Gregory J. Lyons
Robin J. H. Maxwell
William P. Mayer
Philip H. Newman
Sean P. O'Malley
Christopher E. Palmer
Byron C. Pavano
Regina M. Pisa
Mark S. Raffman
Derek N. Steingarten
William E. Stern
Michael P. Whalen

To e-mail any of the above attorneys, use first initial of first name followed by last name followed by @goodwinprocter.com. For example, the e-mail address for Gregory J. Lyons would be glyons@goodwinprocter.com

➤ **SEC Issues Adopting Release for Form D Electronic Filing Requirement and Form D Revisions**

The SEC issued the formal release (the "Release") adopting mandatory electronic filing of Form D, which an issuer uses to provide information to the SEC regarding an offering that relies on certain securities offering exemptions under the Securities Act of 1933, as amended, most notably Regulation D. The Release also discusses amendments to Form D designed to update and simplify certain of its informational and procedural requirements. Electronic filing of Form D will become mandatory on March 16, 2009 following a phase-in period during which electronic filing will be voluntary. The phase-in period begins September 15, 2008. More detailed coverage of this development will appear in a future edition of the *Alert*.

➤ **ICI Issues Model FAS 157 Note Disclosures for Investment Companies**

The Investment Company Institute (the "ICI") published sample note disclosures designed to help registered funds comply with the additional requirements imposed by Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, regarding the methodologies used to value fund holdings. The sample note disclosures are accompanied by a matrix of types of securities and financial instruments intended to assist investment companies in determining where different types of pricing fall in FAS 157's hierarchy of valuation inputs. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. See the September 26, 2006 *Alert* for additional information on FAS 157.

➤ **SEC Approves FINRA Proposal to Eliminate Principal Pre-Approval Requirement for Sales Material Previously Filed by Another Member**

The SEC approved FINRA's proposal to create an exception to NASD Rule 2210's registered principal pre-approval requirements that allows a member firm to use sales material without principal pre-approval, if another firm has filed the sales material and received a letter from FINRA stating that the sales material appears consistent with applicable standards. See the January 15, 2008 *Alert* for a more detailed discussion of the amendment.