

# Financial Services Alert

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## *Developments of Note*

### ➤ **OCC Rules Fixed Rate Cumulative Convertible Preferred Securities Are Investment Securities Permissible for Bank Ownership**

In Interpretive Letter 1086 (“Letter 1086”) the OCC determined that fixed-rate cumulative convertible preferred stock (“Preferred Stock”) to be issued by Countrywide to Bank of America qualified as an investment security under Part 1 of the OCC’s rules, and thus was permissible for a national bank to hold directly. The FRB had previously determined that ownership of the convertible preferred stock did not raise any Bank Holding Company Act issues (see the May 7, 2002 *Alert*).

Letter 1086 provides that preferred stock is a “hybrid instrument” that can be structured as either a debt instrument or common stock. The Preferred Stock had many debt like qualities, including limited voting rights; fixed, quarterly payments; and priority upon a dissolution of the issuer. Moreover, while preferred stock typically is perpetual like common stock, the Preferred Stock was callable by the issuer after 10 years, a feature more characteristic of a debt instrument. Finally, the Preferred Stock is convertible at the option of the purchasing bank, rather than the issuer, which is consistent with Part 1, and under the facts of Letter 1086 the purchasing bank committed not to cause such a conversion.

### ➤ **Federal District Court Dismisses Mutual Fund Shareholder Suit Regarding Affiliated Transfer Agent Arrangements with Leave to Amend Section 36(b) Claim**

The US District Court for the Southern District of New York (the “Court”) dismissed a class action suit brought by investors in a family of mutual funds against affiliates of the organization sponsoring and providing advisory services to the family of funds (such organization and its affiliates being generically referred to as the “Sponsor/Adviser”) and executives of the Sponsor/Adviser regarding transfer agency arrangements (the “Affiliated Transfer Agent Arrangements”) for the funds made with another Sponsor/Adviser entity (the “Transfer Agent Affiliate”). The plaintiffs alleged that inadequate disclosures regarding the funds’ arrangements with the Transfer Agent Affiliate that appeared in regulatory filings by the funds violated the anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934 (the “1934 Act”), as amended, and Rule 10b-5 thereunder, thereby triggering control person liability under Section 20(a) of the 1934 Act, and violated Section 36(b) of the

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Investment Company Act of 1940, as amended, which permits certain actions by fund shareholders against the fund's adviser, its affiliates and certain other related persons regarding the receipt of compensation from the fund. The Court's decision came upon by a motion by the defendants to dismiss the complaint for failure to state a claim under the foregoing statutory and regulatory provisions.

*The Plaintiffs' Claims.* For purposes of its decision, the Court accepted as true certain of the plaintiffs' allegations, detailed as follows. In 1999 the Sponsor/Adviser recommended that the funds enter into the Affiliated Transfer Agent Arrangements. Under those arrangements, the Transfer Agent Affiliate would provide customer service and subcontract all other services to the funds' existing transfer agent, which would perform those services at a 33.5% to 60% discount to the rates it charged when directly engaged by the funds; the Transfer Agent Affiliate would retain the majority of these savings. The Sponsor/Adviser also entered into a side-letter agreement with the existing transfer agent pursuant to which the existing transfer agent agreed to provide investment banking and asset management revenue to the Sponsor/Adviser. The individual defendants named in the complaint were in one instance involved in negotiating the Affiliated Transfer Agent Arrangements, presenting them to the funds' boards and signing the fund filings that contained the disclosure on which the plaintiffs based their claims, and in the other involved in recommending the Affiliated Transfer Agent Arrangements to the funds' boards. During the period when the plaintiffs purchased their fund shares, the funds' public filings, e.g., their prospectuses and shareholder reports, contained disclosures about the funds' contracts for transfer agent services that failed to disclose: (1) the savings accruing to the Sponsor/Adviser under the Affiliated Transfer Agent Arrangements; (2) the fact that the predecessor third party transfer agent continued to perform most transfer agency services under the new agreement; and (3) the side-letter arrangement with the predecessor third party transfer agent. The plaintiffs claimed they relied on these alleged omissions and were injured because: (a) the funds paid more for transfer agent services than were necessary; (b) the plaintiffs purchased shares at distorted net asset values; and (c) the plaintiffs suffered "lost opportunity damages" because the amounts paid in excessive fees could have been invested for further gains.

(In 2005, the SEC settled administrative proceedings against the two entity defendants in this suit over alleged violations of the anti-fraud provisions of the Investment Advisers Act of 1940, as amended, for failure to disclose to the funds' boards (A) the discounted fees at which the predecessor third party transfer agent provided services under the Affiliated Transfer Agent Arrangements and (B) the nature of the side-letter agreement with the predecessor third party transfer agent. The SEC subsequently settled administrative proceedings against an executive of the Sponsor/Adviser, who was not one of the individual defendants in the instant suit, regarding his involvement in negotiating the Affiliated Transfer Agent Arrangements. The SEC also filed suit in federal district court against the two individual defendants in this suit regarding their role in the Affiliated Transfer Agent Arrangements; that case was dismissed earlier this year.)

*The Court's Analysis.* With respect to the plaintiffs' claims under Section 10(b) and Rule 10b-5, the Court found that the plaintiffs had failed to allege a material misrepresentation or omission, one of the required elements of the securities fraud claim the plaintiffs sought to bring. The Court observed that where the total amount of fees paid by a mutual fund for services was disclosed, other information about the fees, such as their allocation or the transfer agent's profit margin, was not material; the amount of fees, not their allocation or the transfer agent's profit margin, was relevant to the price and value of the funds being purchased. Because the plaintiffs were in possession of all material information, there was no material omission. The Court distinguished the current situation from one where total fees were disclosed but a kickback arrangement undergirding the fees tainted the investment advice being provided, and therefore was material to investors. Having found that there was no underlying primary violation of federal securities law, the Court dismissed the plaintiffs' claim for control person liability under Section 20(a) of the 1934 Act. As to the plaintiffs' direct claim under Section 36(b), the Court found that the harm alleged by the plaintiffs, excessive fees paid by the funds, was not distinct to themselves but rather a harm generally to the funds. Given that the Second Circuit has characterized actions under Section 36(b) as a private right of derivative action, the Court dismissed

this count of the complaint but gave the plaintiffs leave to replead it as a derivative claim by October 19, 2007.

### ➤ **SEC and Banking Agencies Speak at Senate Committee Hearing Regarding ILCs**

The SEC, as well as the FRB and FDIC, spoke recently at a hearing concerning industrial loan companies (“ILCs”) before the United States Senate Committee on Banking, Housing and Urban Affairs. Much of the published testimony of the agencies largely reiterated topics on consolidated supervision, and the growth of ILCs, discussed in past issues of the *Alert*. However, the SEC representative, who largely focused on the SEC’s consolidated supervision of the largest US broker-dealers, sought to ensure that Congress would not enact any legislation that would impair the SEC’s role as a consolidated supervisor of ILCs with significant BD affiliates, or that would add a bank regulator to an oversight role in such circumstances. The FRB representative more forcefully asserted that the Congress should fully close the ILC “loophole” currently in the Bank Holding Company Act, and grandfather existing ILCs subject to restrictions like those Congress has implemented when closing similar loopholes in the past. In this regard, the FRB did not believe that currently pending S. 136, the Industrial Bank Holding Company Act of 2007, was appropriate as it still allowed a firm to acquire an ILC in the future and still derive up to 15 percent of its consolidated annual revenues from commercial activities. The FDIC representative sought to largely remain neutral as to which new approach, if any, Congress should take with respect to ILCs. The FDIC representative noted, however, that the current moratorium on non-financial companies acquiring ILCs expires on January 31, 2008, and the “FDIC has the responsibility to consider applications under existing statutory criteria and make decisions. While it is appropriate to proceed cautiously, the FDIC cannot defer action on these matters indefinitely.”

### ➤ **OCC Issues Interpretive Letter Concluding that Directors Qualifying Shares Requirement may be Satisfied Through Holdings of BHC Deferred Share Units**

The OCC issued an Interpretive Letter (“Letter 1087”) in which it concluded that directors of a national bank can meet the requirement under 12 U.S.C. §72 that they hold directors’ qualifying shares through holdings of deferred share units (“Units”) issued by the bank’s parent bank holding company (the “BHC”). The Units are phantom shares that track the value of, and fluctuate in value with, the BHC’s common stock. Holders of Units receive cash amounts equal to dividends paid on the BHC common stock. Unlike BHC common stock, Units bear no voting rights and cannot be transferred or sold on an exchange.

In Letter 1087 the OCC stated that the overriding principle behind 12 U.S.C. §72 is to ensure that the bank director has “a financial stake in the operations of the bank, evidenced by an equity or an equivalent interest.” Since the Units have all of the attributes of BHC common stock other than voting rights and transferability, the OCC concludes that a director can satisfy his or her directors’ qualifying share requirement through holdings of Units.

### ➤ **Department of Treasury Seeks Public Comment on Various Aspects of Financial Regulatory Structure**

The U.S. Department of the Treasury (“Treasury”), in connection with its review of the U.S. financial regulatory structure, published a notice (the “Notice”) seeking public comment on a broad range of topics. The Treasury’s review scheduled for release in early 2008 will focus on “all types of financial institutions, commercial banks and other insured depository institutions, insurance companies, securities firms, futures firms, and other types of financial intermediaries.” Among the topics on which Treasury seeks public comment are: (1) the effects of overlapping state and federal regulation, (2) strength and weaknesses of having multiple regulators and multiple federal charters for financial institutions, (3) how the regulation of financial institutions with government guarantees should differ from regulation of those without such guarantees; (4) whether a “principles-based” approach to regulation

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would be more efficient than a “rules-based” approach to regulation and (5) ways to improve market discipline and consumer protection. Comments are due by November 21, 2007.

### ➤ **FinCEN Issues Guidance on Addressing Common Errors in Filing SARs**

The Financial Crimes Enforcement Network (“FinCEN”) issued guidance (the “Guidance”) for Money Services Businesses and financial institutions in other industries concerning how to address common errors in filing Suspicious Activity Reports (“SARs”). The Guidance states that, when reviewing SARs, FinCEN has often noted errors in the 3 categories noted below.

1. With respect to SAR narratives, FinCEN stresses that often narratives fail to be complete and identify the “Who? What? Where? and When?” of the suspicious activity being reported.”
2. The Guidance also states that there are often errors in providing certain critical fields in the SAR form (*e.g.*, those noting the filer’s Employer Identification Number, the filer’s telephone number and the subject’s Social Security Number). These items of information are key because they allow users of SARs to analyze quickly where the suspicious activity has occurred.
3. FinCEN has also found common errors in SARs that fail to identify the type, category and/or characteristics of the suspicious activity reported.

The Guidance concludes with suggestions by FinCEN on how a financial institution can reduce the number of incomplete or incorrect SARs it files, including suggestions that a financial institution sign-up for BSA E-filing (a system for electronically filing Bank Secrecy Act forms like SARs) and have a second reviewer to ensure accuracy and completeness of SARs.