

Financial Services Alert

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Developments of Note

► Independent Directors Council Issues Report on Board Oversight of Certain Mutual Fund Service Providers

A task force of the Independent Directors Council, an outgrowth of the Directors' Committee of the Investment Company Institute, issued a report on board oversight of mutual fund service provider arrangements with administrators, custodians, fund accounting agents, transfer agents, and securities lending agents. The report, which is designed to offer practical guidance to boards in fulfilling their oversight responsibilities, discusses potential considerations in evaluating (i) service provider agreements, (ii) service provider qualifications and capabilities, (iii) fees, and (iv) potential conflicts of interest, as well as ongoing oversight once a service provider is engaged. The report emphasizes that the nature and extent of a board's involvement in the selection of fund service providers and ongoing oversight of their performance will vary from fund to fund depending on the particular circumstances. The report notes the distinction between a board's oversight role and fund management's day-to-day management responsibilities with respect to fund service providers. After reviewing the general factors a board may wish to use in evaluating service provider agreements, the report describes the particular types of information a board may want to receive, especially from a fund's management and Chief Compliance Officer. With respect to existing service provider arrangements, the report suggests that boards consider how frequently they should reevaluate those arrangements and that, when evaluating such arrangements, boards focus on the quality of services actually provided. In this context, the report notes the practical difficulties associated with switching service providers.

The report then addresses the steps that the board can take to determine whether the fees charged by service providers are fair and reasonable. This portion of the report describes resources available from third parties that can be used to evaluate service provider fees, suggests factors to consider, and discusses how a board may choose to proceed if it determines that a service provider's fees are unreasonable. The report also reviews the role of the board in identifying potential conflicts of interest that may arise in the context of service provider arrangements, particularly in cases where the service provider is an affiliate of the fund adviser. The report identifies situations that may involve conflicts of interest, such as (a) where a service provider waives fees for a new fund (which might result in higher fees for existing funds), and (b) an affiliated service provider subcontracts with an unaffiliated service provider (which may suggest, depending on the relative fees paid to, and duties of, the parties, that the fee paid by the fund could be lower, or which may involve some benefit provided by the unaffiliated

service provider to the affiliated service provider or its affiliates). Here the report focuses on the type of disclosures that a board should seek from fund management and service providers in order to detect any potential conflicts of interest.

Finally, the report addresses the issue of ongoing oversight of service providers, describing the steps the board may take to monitor the nature of the services provided and the type of information the board should seek from fund management and service providers in order to carry out ongoing oversight. The appendices to the report outline the basic range of services provided by each type of service provider and suggest some additional factors a board may wish to consider when analyzing the merits of service providers of each type.

➤ **FDIC Issues Further Guidance on Third-Party Arrangements**

In its summer Supervisory Insights, the FDIC issued further guidance on third-party arrangements. Unlike other outsourcing guidance issued by the banking agencies, this article focuses largely on the risks with the use of third parties to be client facing and sell bank product. The guidance defines “third parties” broadly for these purposes to include a bank or nonbank, affiliated or not affiliated, regulated or nonregulated, domestic or foreign.

The guidance first describes the risks, when acting as principal, that banks encounter in these arrangements. Specifically, (1) strategic risk (third parties offering products and services not core to the bank’s business, or offering such services with risks outweighing the rewards); (2) reputation risk (negative publicity regarding the bank or the third party, even if unrelated to the bank’s arrangement); (3) transaction risk (the third party’s failure to perform as anticipated, *e.g.*, because of inadequate capacity, technological failure or fraud); (4) credit risk (relating to the third party itself, or where the third party does not adequately monitor customer credit); and (5) compliance risk.

The guidance then provides a number of historical examples of troubled third party arrangements. For example, in cases where a third party was sourcing loans for a bank, the guidance cites concerns of inadequate information about borrowers (resulting in unintended credit risk), and inadequate monitoring of the loan brokerage network (resulting in poor origination practices). The guidance also discussed an arrangement with an entity that described itself as specializing in marketing and processing credit cards, only to create a program with fee structures that caused the bank to be in violation of the Federal Trade Commission Act’s unfair and deceptive acts prohibition.

Finally, the guidance provides supervisory perspectives and recommendations. Before entering into any such arrangement, the bank should ensure that the proposed activities are consistent with the bank’s objectives, and that that the parties address critical business issues, such as qualified personnel, technology investments, and proper consumer disclosures and oversight. The bank should conduct due diligence on the third party prior to entering into the arrangement and periodically thereafter. Moreover, bank management should establish proper procedures to monitor and respond to consumer complaints. Finally, the bank’s audit group should independently review third party arrangements, and report its finding to the board of directors, with exceptions immediately addressed.

➤ **MA Appellate Tax Board Holds that MA Can Impose Excise on Certain Out-of-State Financial Institutions Without Physical Presence in MA**

In *Capital One Bank & Capital One F.S.B. v. Commissioner of Revenue*, ATB Docket Nos. C262391 & C262598 (June 22, 2007), the Massachusetts Appellate Tax Board (the “Board”) decided that Massachusetts may impose its financial institution excise on an out-of-state financial institution that does not have a physical presence in Massachusetts if the financial institution engages in deliberate and targeted exploitation of the Massachusetts economic market and uses the Commonwealth’s governmental infrastructure and resources. The banks’ principal claim was that imposition of the excise violated the commerce clause of the U.S. Constitution. Under well-established U.S. Supreme Court case law, one of the requirements for a state tax to comply with the commerce clause is that the

taxpayer have “substantial nexus” with the taxing state. An important unresolved question has been whether substantial nexus requires that a person have a physical presence in the taxing state. In this case, the Board answered that question for Massachusetts as follows:

The Board found and ruled that the Banks’ activities constituted “substantial nexus” with Massachusetts so as to justify imposition of the [financial institution excise], irrespective of whether the Banks had a physical presence in Massachusetts during the years at issue. The Banks’ purposeful, targeted marketing of their credit card business to Massachusetts customers, their required quarterly filing of Credit Card Issuer’s Reports with the Massachusetts Division of Banks, their use of Massachusetts court system and the Massachusetts Attorney General’s Office to collect delinquent accounts and resolve disputes with Massachusetts customers, their use of a sophisticated network, including Visa and MasterCard as well as Massachusetts acquiring banks, which linked them with Massachusetts customers and merchants and by which they, through the customers’ use of “Capital One”-branded cards, guaranteed payment to the merchant on behalf of the customer, and their deriving of hundreds of millions of dollars in income from millions of transactions involving Massachusetts residents and merchants constituted substantial nexus with Massachusetts.

➤ **FinCEN Issues Guidance on SAR Supporting Documentation**

FinCEN issued guidance (the “Guidance”) regarding supporting documentation for suspicious activity reports (“SARs”). The Bank Secrecy Act (“BSA”) requires financial institutions (“FIs”) to provide SAR supporting documentation, if requested, to law enforcement officials and bank regulatory supervisors (each an “Official” or “Supervisor”). The Guidance states that an FI should have procedures in its BSA/anti-money laundering (“AML”) policy that the FI will use to verify that the individual making the request is, in fact, an Official or Supervisor.

The Guidance further states that “supporting documentation” includes all documents or records that assisted the FI in determining that an SAR should be filed. The FI’s BSA/AML procedures should describe the manner in which the FI will maintain the supporting documentation. Moreover, the Guidance points out that no legal process is required for disclosure of supporting documentation. When an FI provides an Official or Supervisor (who is exercising his or her supervisory or regulatory function) with a copy of SAR supporting documentation, the FI is not subject to the Right to Financial Privacy requirement that prohibits FIs from disclosing a customer’s financial records to a government agency “without service of legal process, notice to the customer and an opportunity to challenge the disclosure.”

➤ **Coalition of Mutual Fund Investors Releases Results of Its 2007 Study on the Use of Redemption Fees and Other Means of Deterring Short-Term Mutual Fund Trading**

The Coalition of Mutual Fund Investors (“CMFI”), an Internet-based shareholder advocacy organization, released a study evaluating the redemption fee and anti-market timing policies of the 50 largest mutual fund groups set forth in prospectus disclosure filed with the SEC. The mutual fund groups were identified and ranked by the Financial Research Corporation based on the dollar amount of long-term assets (including assets in exchange-traded funds). The study found that roughly a third of the fund groups evaluated have implemented redemption fees on at least one domestic or international equity fund with virtually all of the remainder using other policies and procedures to deter excessive short-term trading. CMFI noted that all of the fund groups with a redemption fee policy had disclosure indicating that they may exclude, waive or limit the enforcement of redemption fees with respect to omnibus accounts. The study found that all of the fund groups that chose not to impose redemption fees disclosed the existence of limitations on their ability to enforce anti-market timing policies and procedures against omnibus accounts. Finally, the study found that among the 31 fund groups with

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redemption fee policies, more than three quarters disclose that they use the “first in, first out” (FIFO) method of calculating redemption fees; the remainder did not disclose their choice of accounting method in prospectus disclosure (CMFI admitted not having examined statement of additional information disclosure).

The study concludes that redemption fees are an important mechanism to deter market timing and recommends that: (a) financial intermediaries should be required to disclose shareholder identity and transaction information to mutual funds on a “same-day” basis, or when each order is placed, so that funds can (i) monitor shareholder activity at the individual investor level on a contemporaneous basis, (ii) be in a stronger position to ensure uniform application of their anti-market timing policies and procedures and (iii) standardize the disclosure impact of information sharing requirements on intermediaries; and (b) the “last in, first out” accounting method (LIFO) rather than FIFO should be used for redemption fees. A supplement to the study’s findings and recommendations lists for each fund group examined, the particular source documents for the disclosures evaluated, the redemption fee accounting method used, applicable redemption fee standards and selected disclosures regarding limitations/exclusions/waivers of redemption fees and/or market timing policies.