

Financial Services Alert

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Developments of Note

➤ **U.S. Supreme Court Holds That an Insurer which Both Decides Eligibility for ERISA Benefits and Is Responsible for Paying Eligible Claims Has a Structural Conflict of Interest which Should Be Determined on a Case-by-Case Basis**

The U.S. Supreme Court (the "Supreme Court") affirmed by a 6-3 margin an appellate court decision to set aside an insurer's denial of disability benefits. Justice Breyer's majority opinion – joined by Justices Stevens, Souter, Ginsburg, and Alito – addressed the appropriate level of judicial review of an insurer's decision to deny disability benefits where the insurer determined eligibility for benefits and, as is common today, also was the entity responsible for paying valid claims. The Breyer majority was joined in its reasoning (but not holding) by Justice Kennedy, and in its holding (but not reasoning) by Chief Justice Roberts. The Supreme Court held that lower courts should continue to review denials of ERISA benefits under an abuse of discretion standard where an insurer is granted discretionary authority by a plan document, but that the existence of an insurer's conflict of interest should be weighed as a factor indicative of abuse on a case-by-case basis, even in the absence of any evidence that the conflict actually influenced the specific decision to deny benefits.

The facts of the case are as follows: respondent was diagnosed with a heart condition, severe dilated cardiomyopathy, that caused shortness of breath and fatigue. The disability insurer, who was granted discretion under the applicable plan documents to determine eligibility and who was responsible for the payment of appropriate benefits, granted respondent's initial claim for the plan's standard 24 month benefit allowance. The insurer directed the respondent to a law firm to assist her with obtaining Social Security benefits; she was ultimately granted permanent Social Security disability benefits. The insurer then denied a subsequent application by the respondent for additional plan benefits, finding that respondent failed to meet the heightened standards for such benefits because she was "capable of

performing full-time sedentary work.” Respondent sought review by a district court, but was denied relief. She appealed, and the Sixth Circuit Court of Appeals set aside the insurer’s denial of benefits, finding that the insurer abused its discretion based, in part, on its conflict of interest in both determining whether benefits are payable and then being liable to pay eligible benefits. The appellate court also determined that the decision should be set aside for reasons unrelated to the purported conflict, such as the insurer’s alleged failure (i) to properly take into account the contrary finding by the Social Security Administration and other physicians, (ii) to consider additional evidence of the impact of stress as an aggravating factor on respondent’s condition, and (iii) to provide all treating physician reports to its own experts.

In affirming the decision of the appellate court, the Supreme Court’s majority opinion followed its earlier decision in *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989). It agreed that the proper standard of review of the insurer’s denial was whether the insurer abused its discretion. It held that under the specific circumstances of the case, the insurer had abused its discretion. The majority opined on an issue left open in *Firestone*, namely, the proper approach a district court should take where an insurer with discretion over eligibility is also responsible for payment of eligible awards.

The majority first found that such an insurer is conflicted under ordinary principles of trust law, which it held to be encompassed in this regard in ERISA’s articulation of fiduciary standards. The majority then set out to describe how that conflict should be taken into account by reviewing courts. It stated that the conflict should be one of several factors weighed by the district court on a case-by-case basis, with the conflict being afforded more or less importance based on the particular facts of the case. Justice Breyer stated that the conflict should have more importance where circumstances indicate that its existence affected the benefits decision making process, such as where an insurer has “a history of biased claims administration.” Alternatively, the majority opinion explained that the conflict “should prove less important (perhaps to the vanishing point) where the administrator has taken active steps to reduce potential bias and to promote accuracy, for example, by walling off claims administrators from those interested in firm finances, or by imposing management checks that penalize inaccurate decision making irrespective of whom the inaccuracy benefits.” The majority was clear that it was not issuing “a detailed set of instructions” for the district courts.

In a separate opinion, Justice Kennedy agreed with the majority’s standard, but disagreed in the result, finding that the matter should be remanded to the court below for further proceedings to reconsider the insurer’s decision in light of the newly articulated framework. In contrast, the majority held that the ultimate decision of the court below was consistent with the majority’s standard, even if the appellate court did not apply the specific review contemplated, which thus obviated the need for further proceedings.

Chief Justice Roberts concurred in the judgment of affirmance based on his view that the insurer’s denial of benefits was properly set aside as a result of those factors identified by the Sixth Circuit other than the conflict issue. The Chief Justice did not join the majority’s framework for evaluating an insurer’s purported conflict. He criticized the approach as “imprecise,” “overbroad,” and “indeterminate.” He argued that “certainty and predictability are important criteria under ERISA” and that the type of conflict that will now be subject to a case-by-case determination is “a common feature of ERISA plans.” In the Chief Justice’s view, a reviewing court should only hold that a conflict of interest supports a finding of abuse of discretion where “the conflict actually motivated or influenced the claims decisions.”

Justice Scalia dissented, joined by Justice Thomas. The dissenters would have held that “a fiduciary with a conflict does not abuse its discretion unless the conflict *actually* and *improperly motivates* the decision.” (Emphasis added.) Justice Scalia noted that any other standard would depart from the common law of trusts, and also lead to a scenario where an insurer operating under a structural conflict could have its discretion overturned for the same decisions that would not be called into question by an administrator without a similar perceived conflict. Unlike Chief Justice Roberts, however, Justice

Scalia would have reversed the decision below with respect to the grounds unrelated to the conflict issue.

All nine justices agreed that the abuse of discretion standard controls even where a plan fiduciary is alleged to have a conflict of interest in eligibility determinations. However, the majority opinion acknowledges that the weight to be given such conflict on any specific eligibility determination will be decided case-by-case. This may lead to inconsistent standards in the short run as district courts wrestle with specific fact patterns. Additionally, insurers and other plan administrators with dual responsibility for determining eligibility and paying claims will now have occasion to consider whether their practices fit within the newly articulated framework should their decision to deny benefits be challenged in court. (*Metropolitan Life Insurance Co. v. Glenn*, No. 06-923 (S. Ct. June 19, 2008).)

Earlier this session, the Supreme Court addressed a separate question under ERISA relating to the ability of participants of defined contribution plans to sue for losses to their individual accounts .

Goodwin Procter's client Alert on the prior decision can be found here.

<http://www.goodwinprocter.com/~media/C876A66A22DA409E8767F11C548645EA.ashx>. Goodwin Procter litigators have been at the forefront of these and other cutting edge ERISA cases. The slides and audio of a general overview of trends in ERISA litigation as presented by Goodwin Procter's practitioners in February 2008 is available here. [The Rise of ERISA Litigation and its Impact on Collective Trusts](#).

➤ **FDIC Approves ILC Establishment Subject to Numerous Conditions**

The FDIC approved the application of CapitalSource Bank, a California industrial loan company, for Federal deposit insurance, the purchase of certain assets and assumption of certain liabilities from Fremont Investment & Loan ("FIL") and the establishment of 22 of FIL's branches as branches of CapitalSource Bank.

Despite the expiration on January 31, 2008 of the FDIC's moratorium on permitting nonfinancial organizations to charter or acquire industrial loan companies ("ILC"), the FDIC, made the CapitalSource Bank approval subject to numerous conditions. These conditions include, among several others, (i) CapitalSource Bank's parent company, CapitalSource, Inc., divesting its investments in certain non-financial activities prior to the effective date of deposit insurance; (ii) CapitalSource, Inc. executing one or more written agreements that incorporate some or all of the conditions and requirements contained in the FDIC's recently proposed rules regarding certain ILCs (*See* 72 Fed. Reg. 5217, February 5, 2007, as discussed in the February 6, 2007 *Alert*); and (iii) two private equity investors, which own over 10% of CapitalSource, Inc. and engage in commercial activities that are not permissible for a financial holding company or savings and loan holding company, executing passivity agreements that eliminate the investors' ability to control CapitalSource Bank.

The FDIC's moratorium was put in place in July 2006 and extended to January 2008, in order to give Congress time to adopt legislation that would prohibit retailers and other nonfinancial companies from acquiring or chartering ILCs, but Congress adjourned without adopting such legislation. Goodwin Procter wrote an extensive analysis of private equity firms investing in banks more generally in the May 27, 2008 *Alert*.

➤ **Eighth Circuit Rules State Law Securities Claims Brought by Trust Account Beneficiaries Preempted by SLUSA**

In two recent cases, the United States Court of Appeals for the Eighth Circuit (the "Eighth Circuit") upheld the dismissal of related class action lawsuits brought by trust account beneficiaries against a bank (the "Bank") on the grounds that the suits were preempted by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). In both cases, plaintiffs alleged that the Bank failed to make appropriate disclosures regarding the investment of trust account assets in mutual funds managed by a subsidiary of the Bank.

In the first suit, plaintiffs filed federal securities claims and state law claims of unjust enrichment and breach of fiduciary duty against the Bank. The trial court dismissed the federal claims on the merits and dismissed the state claims as preempted by SLUSA. The plaintiffs only appealed the dismissal of the state-law claims and the Eighth Circuit affirmed the dismissal. SLUSA “expressly preempts all ‘covered’ state-law class actions that allege: (1) an untrue statement or omission of a material fact, or (2) use of a manipulative or deceptive device or contrivance, ‘in connection with the purchase or sale of a covered security.’” Plaintiffs conceded that their claim met all of the elements for SLUSA preemption except that the alleged misrepresentation and omission of material facts were not committed “in connection with the purchase or sale of a covered security” because the plaintiffs themselves did not purchase the securities at issue – the Bank did. The Eighth Circuit rejected that argument, holding that “in connection with” must be interpreted broadly since SLUSA was intended to prevent plaintiffs from filing state-law class actions in securities cases. The court followed the rule established by the United States Supreme Court in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006), which stated that “it is enough that the fraud alleged ‘coincide’ with a securities transaction—whether by the plaintiff or by someone else” for it to occur “in connection with” a securities purchase or sale under SLUSA. Applying *Dabit*, the Eighth Circuit held that the Bank’s alleged misrepresentations and omissions “clearly coincided” with its purchases of the stock, since the Bank allegedly omitted information about those specific purchases. Thus, the Eighth Circuit held that the plaintiffs had in fact alleged misrepresentations and omissions “in connection with the purchase or sale of a covered security” and therefore their state-law claims were preempted by SLUSA. (*Siepel v. Bank of America, N.A.*, 2008 U.S. App. LEXIS 10667 (8th Cir. Mo. May 19, 2008).)

In the second suit, plaintiffs sought redress for the same injuries by the Bank that were alleged in the first case. They filed twelve state-law claims, including breach of fiduciary duty, breach of contract, and unjust enrichment. However, unlike the plaintiffs in *Siepel*, they did not concede that they had alleged misrepresentation and omission of facts in their complaint. They attempted to distinguish their complaint from the *Siepel* complaint and argued that their claims should not be preempted because their complaint only alleged “failing to disclose” and “failing to be honest,” which was not the same as alleging “omissions of facts or misrepresentations.” The Eighth Circuit disagreed, holding that such subtle differences in language could not remove their claims from SLUSA preemption. The court held that “SLUSA preemption is based on the conduct alleged, not the words used to describe the conduct.” Since the plaintiffs’ claims were based on the same alleged conduct as in *Siepel*, which included both misrepresentations and omissions, the court found plaintiffs’ claims preempted by SLUSA. (*Kutten v. Bank of America, N.A.*, 2008 U.S. App. LEXIS 12700 (8th Cir. Mo. June 16, 2008).)

➤ **FinCEN Issues Guidance on Clearing Broker-Dealers’ Bank Secrecy Act (“BSA”) Obligations in Relationships with Foreign Financial Institutions**

The Financial Crimes Enforcement Network (“FinCEN”) issued guidance [FIN-2008-R008] that clarifies the Bank Secrecy Act (“BSA”) obligations of clearing broker-dealers establishing fully disclosed clearing relationships with foreign financial institutions. The guidance addressed several issues, including whether a fully disclosed clearing relationship between a U.S. clearing firm and a foreign introducing firm is a “correspondent account” for purposes of Patriot Act Section 312 and whether a U.S. clearing firm must obligate the foreign firm to comply with the BSA with respect to any of the foreign firm’s underlying accounts that are introduced to the clearing firm.

FinCEN began by noting that a clearing relationship between a foreign firm and a U.S. clearing firm constitutes a “formal relationship” and, therefore, a “correspondent account” and “account” for purposes of the Patriot Act. Accordingly, FinCEN noted that the U.S. firm would need (a) to conduct due diligence on the foreign introducing firm under Patriot Act Section 312, and (b) to identify and verify the identity of the foreign introducing firm under Patriot Act Section 326.

At the same time, FinCEN noted that the clearing firm is not obligated to look through the foreign firm to perform due diligence on any underlying customers who may be introduced to the U.S. firm pursuant to the clearing arrangement. FinCEN also stated that the U.S. clearing broker-dealer is not required to

obligate the foreign firm to comply with the BSA or to apply the customer identification program (“CIP”) requirements to underlying accounts of the foreign firm. Instead, according to FinCEN, the clearing firm is expected to monitor the transactions of the underlying customers, incorporating any information the clearing firm obtains about these customers in the ordinary course of the clearing firm’s business.

➤ SEC Proposes to Make Filing of Prospectus Risk/Return Summary Information in Interactive Data Format Mandatory for Mutual Funds

The SEC voted to publish for comment proposed rules that would require open-end management investment companies (“mutual funds”) to make an electronic filing with the SEC that presents the risk/return summary information in their prospectuses in interactive data format and to post that interactive data on their Web sites, and has issued a formal release describing its proposal (the “Proposing Release”). (The risk/return summary appears at the front of the mutual fund prospectuses and includes information about a fund’s investment objectives and strategies, risks, costs (including fee table information) and historical performance.) The SEC’s proposal also would expand the voluntary program for interactive data filings to permit all registered investment companies and certain other filers to submit portfolio holdings information in interactive data format without filing other financial information such as financial statements.

Background. Data tagging labels information in electronic filings using standardized definitions so that the information can be retrieved, searched and analyzed through automated means. Data tagging is designed to increase the ability of investors, analysts and others to collect and use information in disclosure documents filed electronically with the SEC. The SEC website includes a mutual fund comparison tool that demonstrates the use of data tagged information extracted from filings made by funds participating in a voluntary program begun in 2007. The mutual fund comparison tool allows users to compare mutual fund risk/return summary information, including investment objectives and strategies, risks, costs, and performance, that is submitted in interactive data format. The proposed rules build upon the SEC’s voluntary filer program started in 2005. The 2005 program allowed companies to submit financial statements, on a supplemental basis, in interactive data format. In 2007, the SEC expanded the program to allow mutual funds to voluntarily submit, on a supplemental basis, information contained in the risk/return summary section of their prospectuses in interactive data format.

Requirements of the Proposed Rule. The SEC’s proposal would not change the current substantive disclosure requirements for the mutual fund prospectus risk/return summary. The proposal would only require mutual funds to file risk/return summary information in a new format as an exhibit. Under the proposed rules, a mutual fund that files a registration statement or post-effective amendment on Form N-1A that includes risk/return summary information must submit no later than 15 business days after that filing’s effective date a post-effective amendment pursuant to Rule 485(b) under the Securities Act of 1933, as amended (the “1933 Act”), that contains an exhibit presenting the risk/return summary in interactive data format. This follow-on filing would be comparatively brief consisting only of the exhibit, a facing page, a signature page, a cover letter explaining the nature of the amendment, and a revised exhibit index. A mutual fund that maintained a website would also be required to provide the interactive data filed with the SEC on its website by the end of the business day on the earlier of the date that the interactive data was submitted to the SEC or required to be submitted to the SEC. A fund could not fulfill the website posting requirement by providing a hyperlink to the SEC website. The information provided under the proposed requirements would be the same as that currently provided by the mutual funds participating in the voluntary program for filing risk/return summary information using interactive data, which the SEC intends to continue to make available until the effective date for the proposed requirements, if adopted.

Voluntary Program - Portfolio Holdings. The SEC’s proposal would modify the voluntary interactive data filing program to allow (i) investment companies registered under the 1940 Act, (2) business development companies, and (3) other entities that report under the Securities Exchange Act of 1934, as

amended, and prepare their financial statements in accordance with Article 6 of Regulation S-X, to submit exhibits under the voluntary interactive data program that contain a tagged schedule of portfolio holdings, specifically Schedule I - Investments in Securities of Unaffiliated Issuers under Regulation S-X, without having to submit other financial information, such as financial statements, in interactive data format. As under the voluntary program currently, a tagged exhibit with portfolio holding information would have to disclose that (a) the financial information is “unaudited” or “unreviewed,” as applicable, and that the purpose of submitting the tagged exhibit is to test the related format and technology and, as a result, investors should not rely on the exhibits in making investment decisions. The SEC’s proposal would not affect the ability of registered investment companies to participate in the voluntary program that permits certain issuers to file their financial statements in interactive data format. (Financial statement filings submitted by investment companies under the voluntary program consist of a complete set of financial statements that reflects all periods presented in the corresponding official EDGAR filing, which may omit notes to the financial statements and related schedules, other than Schedule I – Investments in Securities of Unaffiliated Issuers, and financial highlights or condensed financial information. Voluntary financial statement filings may also include related audit opinions, interim review reports, reports of management on the financial statements, certifications, or Management’s Discussion of Fund Performance.)

Liability. In general terms, interactive data on its own would not be subject to various liability provisions under the federal securities laws that apply to filings with the SEC and certain offering materials, but would be subject to liability for their substantive content under other provisions of the federal securities laws. In addition, the substantive content of interactive data when made viewable by software on the SEC website would be subject to the same liability under the federal securities laws as the corresponding risk/return summary in the traditional prospectus filed in the mutual fund’s registration statement, provided the two disclosures were identical in all material respects. The proposed rules include provisions that would protect a mutual fund from liability for violations of the proposed technical filing and coding requirements if (A) the mutual fund failed to meet those requirements despite its good faith and reasonable effort, and (B) the mutual fund corrected the failure as soon as reasonably practicable after it became aware of the failure. The Proposing Release notes that mutual funds may choose to rely on financial printers, consultants, and software companies for assistance in preparing filings, but would retain ultimate responsibility for both their risk/return summary information and their tagged data.

Consequences of Non-Compliance. Under the SEC’s proposal, a fund that did not provide a required interactive data submission, or post the interactive data on its website as required, would have its ability to file post-effective amendments under Rule 485(b) automatically suspended, the only exception being a future filing made solely to submit interactive data, which would enable the fund to cure the deficiency. (Rule 485(b) provides for immediate effectiveness of amendments that update a fund’s financial statements (the annual update) and make non-material and certain other changes. A fund unable to file under Rule 485(b) must generally file under Rule 485(a) which permits an effective date on the sixtieth day after filing at the earliest (subject to acceleration at the SEC staff’s discretion). The SEC’s proposal would include a continuing hardship exemption similar to the one already available for electronic filers.

Other Aspects. The Proposing Release highlights a number of anticipated benefits of the proposal to mutual funds, third parties and the SEC itself. Among the potential benefits for mutual funds is that interactive data could provide a significant opportunity to automate regulatory filings and business information processing, with the potential to increase the speed, accuracy, and usability of mutual fund disclosure and lower costs. The Proposing Release also posits that a mutual fund that introduced standardized interactive data format at earlier stages of its reporting cycle could reduce the need for repetitive manual data entry and with it, the likelihood of human error.

The SEC staff expects that its ability to use software to review filings in interactive data format would increase the number of filings that it could review. The Proposing Release discusses the anticipated use of validation software to check interactive data for compliance with applicable technical requirements

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and to identify problematic data. The software would also enable the SEC staff to easily identify and count non-standard special labels and tags. Although the SEC anticipates that the list of interactive data tags would be sufficiently developed to support the range of disclosures funds are likely to make in the risk/return summary, XBRL, the taxonomy for the interactive data format, is extensible, which allows a mutual fund to add to the standard list of tags to accommodate circumstances the standard list does not address. However, to promote comparability across funds, the SEC would limit the use of extensions to circumstances where the appropriate element does not exist in the standard list of tags and would require that wherever possible, preparers change the label for an element that exists in the standard list of tags, instead of creating a new customized tag.

Implementation and Public Comment. If the proposed rules are adopted this fall, the SEC envisions that the proposed requirements would become mandatory beginning with initial registration statements, and post-effective amendments that were annual updates to effective registration statements, that became effective after December 31, 2009. As discussed above, if the SEC adopts the proposed filing requirements for risk/return summary information in interactive data format, it intends to eliminate the risk/return summary information component of the voluntary interactive data program after the compliance date for mandatory filing. The SEC has requested public comment on many specific aspects of its proposal. Comments on the proposed rules should be submitted on or before August 1, 2008.

➤ **SEC Staff Provides No-Action Relief for Family Investment Vehicles to Maintain Qualified Purchaser Status Despite Non-Family Member Investor**

The staff of the SEC's Division of Investment Management issued a no-action letter indicating that several funds that are qualified purchasers by virtue of being "family companies" under Section 2(a)(51)(A)(ii) of the Investment Company Act of 1940, as amended (the "1940 Act"), would not lose that status if the funds' executive director, who has no spousal or family relationship with any of the funds' investors, is allowed to become a fund investor. Each investor in an investment vehicle relying on Section 3(c)(7) under the 1940 Act must at the time of purchase be a qualified purchaser or a "knowledgeable employee" as defined in Rule 3c-5 under the Act. In general terms, under Section 2(a)(51)(A)(ii), an entity that (a) is owned directly or indirectly by individuals who are related by birth, adoption or marriage and (b) has at least \$5 million in investments, is a "qualified purchaser." The family funds sought no-action relief because if they admitted the executive director as an investor they would no longer be "family company" qualified purchasers, and would be unable to meet the conditions of the other qualified purchaser categories. In granting relief, the SEC staff noted its particular reliance on the fact that (a) the executive director is both a knowledgeable employee of the family funds and a qualified purchaser, and is primarily responsible for all the family's investment decisions, and (b) the family's investment committees have indicated that they want the executive director to align his interests with those of the funds by becoming a fund investor.

Other Item of Note

➤ **OCC Issues Summary of Key 2007 Developments for National Banks**

The OCC issued a booklet entitled *2007 Significant Legal, Licensing, and Community Development Precedents for National Banks*, in which the OCC summarizes key developments in 2007 for national banks with respect to banking and securities activities, enforcement actions, investments (including community development investments), preemption and the OCC's Lending Limit Pilot Program.