

Financial Services Alert

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Developments of Note

➤ **New York State Trial Court Dismisses Suit by Hedge Fund Limited Partners Against Hedge Fund's Prime Broker**

A New York State trial court (the "Court") dismissed a complaint filed by limited partners of a hedge fund now in receivership against the fund's former prime broker, custodian and clearing broker (the "Prime Broker"). The complaint alleged that the Prime Broker had engaged in fraud, constructive fraud, breach of fiduciary duty, aiding and abetting fraud and breach of fiduciary duty, negligence, unjust enrichment and tortious interference with a contract, in connection with activity engaged in by the Prime Broker in a particular company's microcap stock, the decline in whose price ultimately resulted in the fund's failure.

Plaintiffs' Claims. As alleged in the complaint, the fund's investment manager caused the fund to accumulate a large position in the microcap stock, in excess of limitations in the fund's offering memorandum. The Prime Broker was allegedly aware that the position was in excess of the fund's investment restriction and that the position also triggered SEC reporting requirements with which the fund was not complying. The complaint averred that the Prime Broker began manipulating the market for the microcap stock by artificially creating a short market in the security that eventually caused a reduction in the value of the fund's portfolio such that the fund was unable to honor redemption requests. The fund was subsequently placed into receivership. The fund's portfolio manager eventually pleaded guilty to violations of federal securities laws in connection with his management of the fund.

The Court's Analysis. The Court rejected the plaintiffs' attempt to characterize their causes of action against the Prime Broker as direct rather than derivative. The Court found that the injury for which the plaintiffs sought redress was foremost an injury to the fund rather than an independent injury to the investor plaintiffs, and thus any claims arising out of the Prime Broker's alleged wrongdoing that caused the decline in the value of the fund's holdings must be asserted directly by the fund, or

derivatively on its behalf. On this basis the Court held that the plaintiffs lacked standing to assert their fraud, constructive fraud, breach of fiduciary duty, aiding and abetting fraud and breach of fiduciary duty, and negligence claims.

The Court also found that mere allegations that the Prime Broker served as the fund's prime broker, clearing broker and custodian were, without more, insufficient to establish a fiduciary relationship between the Prime Broker and the fund's investors. The Court further found that the plaintiffs did not plead facts demonstrating that the Prime Broker rendered substantial assistance to the fund's investment manager in breaching his duty to the fund's investors, sufficient to support the aiding and abetting causes of action, and noted that "[i]n fact, plaintiffs' allege that [the investment manager's] alleged scheme ran counter to [the Prime Broker's], insofar as [the investment manager] allegedly could not complain to the authorities, because that would have revealed his own violation of federal securities laws."

➤ SEC Settles Enforcement Proceeding over Adviser's Failure to Follow Mutual Funds' Investment Restrictions

The SEC settled an enforcement proceeding against a mutual fund investment adviser (the "Adviser") for violations during the period 2001-2005 of certain investment restrictions (the "Restrictions") that prohibited the Funds it advised (the "Funds") from investing in companies that derive revenue from certain activities. The Funds held themselves out as socially responsible funds on the basis of the Restrictions, which were referenced in the Funds' prospectuses, statements of additional information and other materials filed by the Funds with the SEC, and in communications to Fund shareholders and the Adviser's reports to the Funds' board. The SEC found that the Adviser had failed to comply with Restrictions, which, among other things, were to be enforced not only at the time a security was purchased but throughout the entire period that the security was held by a Fund. In addition, the Restrictions were fundamental, *i.e.*, any amendment to a Restriction for a Fund was subject to a vote of the Fund's shareholders.

Investment Screening - Policies and Practice. The SEC noted that the Adviser had adopted "screening" policies and procedures designed to enable it to enforce the Restrictions. The Adviser maintained a department responsible for "screening" companies for compliance with the Restrictions, and portfolio managers could purchase only securities that this department had screened for compliance with the Restrictions and approved for purchase. These policies, which were disclosed to the Funds' board of directors, were not, however, consistently followed.

Additionally, the SEC noted that although the Registration Statements indicated that the Adviser continuously monitored each Fund's portfolio for compliance with the Restrictions, the Adviser did not implement procedures addressing this claim until 2004, when it adopted a policy of screening every Fund holding once each six months, a policy with which the Adviser did not consistently comply. The SEC also found that until late 2005 the Adviser permitted portfolio managers to add to an existing position whether or not the holding had been screened within the preceding sixth-month period as required under the policy. The SEC noted that the Adviser reported regularly to the Funds' board regarding divestments of securities that did not comply with the Restrictions, but failed in certain instances to note that the securities being divested had not complied with the Restrictions when purchased.

The settlement order provides a number of statistics regarding the violations found by the SEC, including the following : (1) from 2001 through 2005 the Adviser purchased ten securities (the "Restricted Purchases") prohibited by the Restrictions for two of the funds; (2) six of the Restricted Purchases had been listed by the Adviser as having failed their most recent screen and the remaining four failed a screen conducted immediately after purchase; and (3) the Adviser failed to pre-screen approximately 8%, 16% and 5% of securities purchased for each of three Funds.

Remedial Action by the Adviser. The settlement order notes that in 2005 the Adviser took steps to enhance its compliance with the Restrictions by replacing certain senior management staff (including certain portfolio managers and the Chief Compliance Officer of the Funds), developing and distributing a new compliance manual and implementing new computer software to assist in compliance with the Restrictions.

Violations and Sanctions. The SEC found that by failing to comply with the Restrictions the Adviser had (1) willfully violated Section 206(2) of the Advisers Act, which in general terms holds investment advisers to a non-scienter based anti-fraud standard in their conduct towards their clients, (2) caused the Fund's violations of Section 13(a)(3) of the 1940 Act, which prohibits a fund from deviating from a fundamental policy including one identified in its prospectus or statement of additional information as such, and (3) willfully violated Section 34(b) of the 1940 Act, which, in relevant part, prohibits an untrue statement of a material fact in documents filed with the SEC. Under the terms of the settlement, the Adviser is subject to a cease and desist order and censure, and will be required to pay a civil money penalty of \$500,000.

➤ US Court of Appeals for Sixth Circuit Rules for Federal Savings Bank in Federal Preemption Case Regarding Agents

The US Court of Appeals for the Sixth Circuit (the "Court") ruled that the mortgage lending activities of a third party that is an exclusive agent of a federal savings bank obtain the benefit of preemption from the Home Owners' Loan Act, reversing a 2007 trial court decision. Following the reasoning of the US Supreme Court's decision in *Watters v. Wachovia*, the Court found that since the *activity* being challenged – mortgage lending – was both field preempted and expressly preempted by HOLA, Ohio could not force the exclusive agents of a federal thrift to register with the state before originating loans in Ohio. The Court said that "it is the activity being regulated rather than the actor who is being regulated that matters" for purposes of preemption. Also, as in *Watters*, the Court made its determination without analyzing whether the OTS' opinion that the activity was preempted was entitled to deference. In the first footnote of its opinion, however, the Court suggests that the federal Housing and Economic Recovery Act of 2008, which was enacted on July 30, 2008 (and established certain new licensing and registration requirements under a system designed by the Conference of State Bank Supervisors) may supersede the Court's decision at some point in the future. *State Farm Bank, FSB v. Reardon*, No. 07-4260 (6th Cir. Aug. 22, 2008).

➤ OCC Issues Interim Final Rule Regarding National Banks' Authority to Make Broader Range of Public Welfare Investments

The OCC issued a bulletin regarding its interim final rule (the "Interim Rule") that, pursuant to the Housing and Economic Recovery Act of 2008 (enacted on July 30, 2008), broadened the range of community development investments permissible for national banks. Specifically, the Interim Rule authorizes a national bank to make a broader range of investments "designed primarily to promote the public welfare, including the welfare of low – and moderate – income communities or families (such as by providing housing, services or jobs)." The Interim Rule became effective on August 11, 2008, but public comments on the Interim Rule were requested by the OCC and are due by September 10, 2008.

➤ FDIC Implements Loan Modification Plan For IndyMac

The FDIC announced that it was implementing a loan modification plan (the "Plan") to systematically modify troubled mortgages at IndyMac Federal Bank, FSB ("IndyMac Federal"). On July 11, 2008, the OTS closed IndyMac Bank, FSB (the "Predecessor Thrift"), and the FDIC was appointed as receiver of the Predecessor Thrift and opened a new institution, IndyMac Federal.

Under the Plan (which affects first mortgage loans either held or securitized by the Predecessor Thrift), modified loans will be capped at the Freddie Mac prime survey rate for conforming mortgages of 6.5% and must achieve a debt-to-income ratio of 38%, including taxes and insurance. The modified loans

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also may receive principal forbearance, waiver of certain fees and an extension of payment terms. The FDIC stated that it has two goals in undertaking the Plan: (1) keeping borrowers in their homes; and (2) increasing the value of IndyMac Federal to a potential buyer.

➤ FDIC Proposes Rule Concerning Qualified Financial Contracts Recordkeeping Requirements

The FDIC proposed recordkeeping requirements (the "Proposed Rule") for qualified financial contracts ("QFCs") held by insured depository institutions in a troubled condition ("Troubled DIs" and each a "Troubled DI"). QFCs are financial contracts such as securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements that, under the Federal Deposit Insurance Act, receive special expedited netting treatment in the event of a Troubled DI's failure.

Under the Proposed Rule, a Troubled DI would be required, upon written notification by the FDIC, to produce immediately at the close of processing of the Troubled DI's business day:

- Electronic files for certain position-level and counterparty-level data;
- Electronic or written lists of QFC counterparty and portfolio location identifiers;
- Certain affiliates of the Troubled DI and the Troubled DI's counterparties to QFC transactions;
- Contact information and organizational charts for key personnel involved in QFC activities;
- Contact information for vendors; and
- Copies of key agreements and related documents for each QFC.

Comments on the Proposed Rule are due by September 26, 2008.

Other Item of Note

➤ Goodwin Procter Sponsors Seminar on Private Equity Investing in Banks

With the capital markets in a state of transition and banks, in particular, looking for new sources of capital, our latest M&A event couldn't come at a more opportune time. Held in New York on Oct. 2, ***Private Equity Investing in Banks: Opportunities in a Perfect Storm*** will examine the latest trends in this sector of the M&A market as regulators consider ways to alleviate the burden of private equity investing in banks. Several private equity funds are being raised to invest in the banking industry, while a growing number of banking institutions are considering acquisitions, selling minority stakes or putting themselves up for sale.

Join some of the biggest names in the industry on October 2, at the Le Parker Meridien in New York City and hear from experts from both the M&A and banking communities. Anchored by keynote speaker **Randy Quarles, Managing Director with The Carlyle Group**, and former Under Secretary of the Treasury, our panel will provide insights into this evolving sector. You will have ample opportunities for both learning and networking with bank executives, private equity firms, hedge funds and investment banks.

For more information or to register, click here: <http://www.sourcemediaconferences.com/FMA08/>