

Financial Services Alert

Goodwin Procter LLP, a firm of 850 lawyers, has one of the largest financial services practices in the United States.

New Subscribers, Past Issues and Background Material: If you would like anyone else to receive issues of the Financial Services Alert, would like to receive any past issues, or would like the background materials for any of the matters discussed in this issue, please contact **Greg Lyons, Eric Fischer, Elizabeth Shea Fries** or **Jackson Galloway** at 617.570.1000 or at the e-mail addresses referenced at the end of this newsletter.

Alert on the Web: Back issues of the *Alert* are available at <http://www.goodwinprocter.com/Publications/FinancialServicesAlerts/Archive.aspx>

Disclaimer: This publication, which may be considered advertising under the ethical rules of certain jurisdictions, is provided with the understanding that it does not constitute the rendering of legal advice or other professional advice by Goodwin Procter LLP or its attorneys.

©2008 Goodwin Procter LLP
All rights reserved.

In this issue:

Developments of Note

1. Seventh Circuit Rejects *Gartenberg* Analysis in Affirming District Court's Dismissal of Excessive Fee Suit Against Mutual Fund Adviser
2. OCC Responds to Agreements between OFHEO, the NYAG, and Fannie Mae and Freddie Mac
3. European Commission Reexamines Supervision of Securities, Banking and Insurance Sectors
4. FDIC Proposes Amendments to its Guidelines for Appeals of Material Supervisory Determinations

Developments of Note

➤ **Seventh Circuit Rejects *Gartenberg* Analysis in Affirming District Court's Dismissal of Excessive Fee Suit Against Mutual Fund Adviser**

The US Court of Appeals for the Seventh Circuit (the "Seventh Circuit") affirmed the dismissal by the US District Court for the Northern District of Illinois (Eastern Division) (the "District Court") of an excessive fee suit brought under Section 36(b) of the Investment Company Act of 1940, as amended (the "1940 Act"), against an adviser (the "Adviser") of registered open-end funds (the "Funds") by Fund shareholders. On appeal, the plaintiffs argued that the Adviser had breached the fiduciary duty with respect to compensation that it owed the Funds under Section 36(b) because the fees it charged the Funds for its advisory services were disproportionate to the value of those services, as evidenced by the fact that the Funds' fees exceeded those charged the Adviser's institutional clients whose accounts were being managed using similar investment strategies. The plaintiffs also argued that the District Court erred in using the multi-factor analysis for suits under Section 36(b) of the 1940 Act established by the US Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F2d 923 (2d Cir. 1982) ("*Gartenberg*").

The District Court Decision. In granting the Adviser's motion for summary judgment, the District Court analyzed the allegations in the complaint and the evidence adduced in their support using the *Gartenberg* factors, e.g., the comparability of a fund's fees to other similar funds; the cost to the adviser to provide services to the fund; the nature and quality of the services provided, including the fund's performance history; whether and to what extent the fund's adviser realizes economies of scale as the fund's assets increase; and the conduct of, expertise, and level of information possessed by the fund directors charged with approving the fee. Based on its *Gartenberg* analysis, the District Court determined that the evidence proffered by the plaintiffs established that others paid different amounts for similar services, but did not support a reasonable inference that the difference was enough to put the amounts charged outside of the range that could be expected to result from arms'-length bargaining.

The Seventh Circuit's Decision. The Seventh Circuit's opinion was written by Chief Judge Easterbrook, who, along with his Seventh Circuit colleague Judge Posner, is noted for his economics-based approach to legal analysis. The opinion places heavy emphasis on the role of market forces in controlling mutual fund advisory fees. Although it affirmed the District Court's decision, the Seventh Circuit explicitly rejected the *Gartenberg* approach. The Seventh Circuit held that Section 36(b) does not establish a reasonable fee standard to be set by the judiciary, rather it imposes a fiduciary duty grounded in the law of trusts. The Seventh Circuit explained: "[a] fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but it is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than

a judge or jury, determine how much advisory services are worth.” Citing examples of situations in which fiduciary duty applies to the determination of compensation, the Seventh Circuit explained that “... the rule in trust law is straightforward: [a] trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay.” The Seventh Circuit observed that it could imagine circumstances where a fiduciary’s compensation could be so outside established norms that a court could “infer that deceit must have occurred, or that the persons responsible for decision [sic] have abdicated...” However, in this instance, the Seventh Circuit found that the plaintiffs “do not contend that [the Adviser] pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services. The fees are not hidden from investors – and [the Funds’] net return has attracted new investment rather than driving investors away.”

The Seventh Circuit expressly rejected the plaintiffs’ claim that mutual fund fees must be judged against the fees charged to an adviser’s institutional clients, stating that, “[d]ifferent clients call for different commitments of time,” and describing specific differences between managing mutual funds and managing institutional accounts. In addition, in rejecting *Gartenberg*, the Seventh Circuit rejected the plaintiffs’ request that the court be guided in interpreting Section 36(b) by the statutory provision’s legislative history, as the *Gartenberg* court had been.

Potential Impact of the Seventh Circuit’s Decision. The long-term implications of the Seventh Circuit’s decision are not clear. The standard set forth in *Gartenberg* remains the law in the Second Circuit, and has been followed by district courts in other circuits; furthermore, the Securities and Exchange Commission relied on certain factors discussed by the *Gartenberg* court in establishing disclosure requirements for board approval of advisory contracts. The Seventh Circuit decision does, however, establish a split in the circuit courts, thereby creating the possibility that the current plaintiffs, or future litigants in a Section 36(b) suit, may petition the U.S. Supreme Court to decide what standard properly applies under Section 36(b). (*Jones v. Harris Associates*, No. 07-1624 (7th Cir. 2008).)

➤ **OCC Responds to Agreements between OFHEO, the NYAG, and Fannie Mae and Freddie Mac**

The Office of Federal Housing Enterprise Oversight (“OFHEO”), the regulator of Fannie Mae and Freddie Mac, announced it had executed “Home Valuation Protection Program and Cooperation Agreements” (the “Agreements”) with the Attorney General of the State of New York (“NYAG”) and Fannie Mae and Freddie Mac. A “Home Valuation Code of Conduct” (“Code”) accompanies the Agreements. The objective of the Agreements and Code, which were entered into to settle the NYAG’s investigation of Fannie Mae and Freddie Mac, is to enhance appraisal and evaluation services relating to mortgages that Fannie Mae and Freddie Mac buy or guarantee. The Agreements and Code seek to accomplish this goal by imposing property appraisal conditions on lenders that sell loans to Fannie Mae and Freddie Mac, including, among other requirements, the elimination of broker-ordered appraisals and the restriction of the use of appraisals prepared in-house or through affiliate appraisal management companies in underwriting mortgages.

In a letter (the “Letter”) dated May 27, 2008 to the Director of OFHEO, the Comptroller of the Currency (“Comptroller”) sets out the views of the OCC regarding the Agreements and Code. The Letter states that the OCC does not concur with the Agreements and Code and believes that they should be withdrawn because of their likely unintended adverse consequences for the safe, sound, and efficient operation of national banks’ residential mortgage lending activities and because they violate or conflict with Federal law in fundamental respects.

Unintended Consequences. The unintended consequences of the Agreement and Code noted in the Letter include the following:

- Major portions of the Code would undermine, rather than enhance, the quality and reliability of appraisals.

- Forcing lenders to change their appraisal processes and to adopt less efficient, and potentially less reliable, processes could significantly increase lenders' origination costs, resulting in an unnecessary increase of the cost of mortgage loans for consumers without a corresponding enhancement of protections and other consumer benefits.
- Compliance with the Code will likely disrupt the mortgage appraisal processes that generally are functioning well for depository institutions and consumers. For example, the Code will restrict lenders' ability to use appraisals obtained from certain appraisal providers, which will lead to market inefficiencies and higher origination costs, as well as unnecessary delays and possible job terminations.
- Implementation of the Code will likely reduce, or at best slow, the availability of soundly written mortgage credit, which will undermine the various ongoing federal efforts to restore credit availability and confidence in the housing and mortgage markets.

Legal Issues. The Comptroller also states in the Letter that the Agreements and Code present substantive legal issues. The Comptroller asserts that, together, the Agreements and Code constitute a "rule," as defined in the federal Administrative Procedures Act ("APA"), establishing binding norms of wide applicability that should have been adopted pursuant to the processes required by the APA and other federal statutes that govern federal agency rulemaking, including notice-and-comment procedures and cost-benefit analyses. Furthermore, it is the OCC's view that the *de facto* rulemaking process represented by the Agreements and Code exceeds the scope of authority of OFHEO and the NYAG. The Agreements and Code conflict with the OCC's exclusive authority under 12 U.S.C. § 371 to regulate and supervise national banks' real estate lending activities, which encompasses national banks' arrangements and procedures for assessing the value of the collateral securing their loans. Moreover, the Comptroller states that the Agreements and Code embody an impermissible sharing by OFHEO of authority with the NYAG. Accordingly, the OCC believes that the National Bank Act prevents the Agreements and Code from being applied to, or enforced against, national banks. The Letter states that "[i]f new national standards are needed to supersede the standards based on current Federal law, we believe those new standards should be determined by Congress, not imposed as the result of the settlement of private litigation between parties."

➤ **European Commission Reexamines Supervision of Securities, Banking and Insurance Sectors**

The European Commission published a consultation paper (the "Paper") to explore the views of interested parties on potential revisions to the Commission Decisions, which established the Committee of European Securities Regulators ("CESR"), the Committee of European Banking Supervisors ("CEBS") and the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS" and, together with CESR and CEBS, the "Committees of Supervisors"). This new initiative follows intensive discussions in 2007 and 2008 on the scope of activities of the Committees of Supervisors which, according to the Paper, resulted in a broad consensus that "the responsibilities of the Committees of Supervisors should be aligned, clarified and strengthened to ensure an enhanced contribution to supervisory cooperation and convergence at [the European Union] level." The current financial turmoil has further highlighted the need to strengthen EU financial stability arrangements.

The Paper does not call for a radical overhaul of the existing supervisory system, but rather proposes more limited revisions in order to (i) introduce greater consistency between each of the Commission Decisions establishing the Committees of Supervisors and (ii) establish a clearer framework for the activities of the Committees of Supervisors in the area of supervisory cooperation and convergence. For example, the Paper provides that the Committees of Supervisors should intensify work in the area of streamlining reporting requirements and should also encourage and facilitate the process of developing a common supervisory culture in the EU. In addition, the Paper discusses the proposed role of the Committees of Supervisors with regard to the proposal to establish "colleges of supervisors" in order to improve the supervision of cross-border financial groups.

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
John Hunt
James J. Kelly
Satish M. Kini
Thomas J. LaFond
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

All interested parties are invited to comment on the Paper by July 18, 2008.

➤ **FDIC Proposes Amendments to its Guidelines for Appeals of Material Supervisory Determinations**

The FDIC issued proposed amendments (the “Amendments”) to its Guidelines for Appeals of Material Supervisory Determinations (the “Guidelines”). The purposes of the Amendments, said the FDIC, are to conform the FDIC’s appellate process to the requirements of the Riegle Community Development and Regulatory Improvement Act of 1994 (the “Riegle Act”) and to “better align” the FDIC’s Supervisory Appeals Review Committee (“SARC”) process with the appeals procedures used by the other federal banking agencies.

Section 309(a) of the Riegle Act requires the FDIC and other federal banking agencies to establish an independent intra-agency appellate process to review material supervisory determinations. The review must be made by an agency official who does not directly or indirectly report to the agency official who provides the determination under review. “Material supervisory determinations” are defined by the Riegle Act as determinations related to: (1) examination ratings; (2) adequacy of the loan loss reserve provision; and (3) classifications on loans that are significant to the bank. Determinations underlying enforcement actions, such as the citations of apparent violations of law, have been appealable under the Guidelines since the enactment of the Guidelines in 1995. However, the FDIC has now determined that such appeals to the SARC are inconsistent with the Riegle Act because, under the Riegle Act, appeals are “not supposed to impair, in any way, the agencies’ litigation or enforcement authority.”

The Amendments would eliminate the ability of an FDIC-supervised bank to file an appeal to the SARC “with respect to determinations or [regarding] the facts and circumstances underlying a formal enforcement-related action or decision, including the initiation of a formal investigation.” The FDIC said that adoption of the Amendments would meet the objectives of satisfying the Riegle Act requirements and better aligning FDIC supervisory determination appeals processes with those used by the other federal banking agencies.

In addition, under the Amendments, when an FDIC official with authority to initiate a formal enforcement action decides that the facts and circumstances warrant the issuance of an enforcement action, the FDIC will send a letter to the applicable bank notifying the bank of the FDIC’s decision to pursue formal action, and the issuance of the foregoing letter by the FDIC will (unlike the practice under the current Guidelines) cut-off the bank’s rights to appeal the facts and circumstances underlying the FDIC’s determination.

Comments on the Amendments are due to the FDIC no later than July 28, 2008.