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Developments of Note

➢ District Court Upholds Continuing Preemption upon Transfer of National Bank Assets; Rejects Contingent Attorneys Fees under FDCPA

The United States District Court for the District of Minnesota (the "District Court") reviewed a plaintiff's claim that a defendant nonbank collection agency had violated the Fair Debt Collection Practices Act ("FDCPA") by (1) charging an impermissible rate of interest; and (2) misrepresenting their entitlement to attorneys fees. The defendant had received via assignment a defaulted credit card debt from a national bank.

As to the plaintiff's first claim, the District Court noted that seeking to collect interest at a rate impermissible by law constituted a violation of the FDCPA, and the rate specified in the credit card agreement exceeded that permissible under Minnesota law. However, the District Court determined that the National Bank Act ("NBA") permits a national bank to charge the interest rate allowed by the laws of the state in which the bank is located, in this case Delaware. Delaware law did permit the rate stated in the cardholder agreement. Moreover, even though the defendant itself was not a national bank, the District Court cited other precedent and held that a court should look at the originating bank and not the assignee to determine whether the NBA applies. As a result, the District Court supported the defendant's position that the interest rate did not violate FDCPA.

As to attorneys fees, in state court the defendant collection firm's complaint had sought a fixed dollar amount for legal fees. The defendant had engaged its collection attorneys on a contingency fee arrangement. The plaintiff thus asserted in District Court that the defendant had sought to collect attorneys fees in violation of the FDCPA. In support of his claim, plaintiff alleged that these fees were not incurred at the time of the complaint (because, as contingency fees, they only would be due if the case were successful), and the cardholder agreement provided that a defaulted debtor would pay "all collection expenses actually incurred" and "reasonable fees" of an outside attorney, and thus the defendant had misrepresented its entitlement to those fees in the complaint in violation of the FDCPA. The District Court concurred with the plaintiff as to this matter.

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➢ California Appellate Court Rules that Attorney General's Suit Against Broker-Dealer over Revenue Sharing on Mutual Fund Sales not Pre-Empted by NSMIA

The California Court of Appeal for the Third Appellate District (the "Appellate Court") reversed a trial court's dismissal of an action brought by the California Attorney General against a brokerage firm alleging that the firm had failed to adequately disclose to investors and potential investors certain "shelf-space agreements" (also known as "revenue sharing agreements") under which the brokerage firm received additional compensation for special benefits provided in its sales efforts for certain preferred mutual fund families. The Appellate Court found that the action was not preempted by the National Securities Markets Improvement Act of 1996 ("NSMIA") or Rule 10b-10 under the Securities Exchange Act of 1934, as amended. In its suit, the Attorney General alleged that the brokerage firm entered into shelf-space agreements with certain mutual fund families under which the fund families paid additional compensation in exchange for heightened visibility in the brokerage firm's distribution systems. The Attorney General further alleged that the brokerage firm failed to inform investors and potential investors in those fund families of sufficient facts to alert them to the existence of the shelf-space agreements, the consideration paid under the agreements, the brokerage firm's obligations under those agreements, or the potential and/or actual conflicts of interest created by those agreements. Relevant disclosure in the fund families' prospectuses and statements of additional information indicated only that "from time to time additional cash bonuses or other incentives [are] made to selected participating brokers in connection with the sale or servicing of mutual fund shares and on occasions such bonuses or incentives may be conditioned upon the sale of a specified minimum amount of those shares." Among other relief, the Attorney General sought injunctive relief, civil penalties and disgorgement.

The Trial Court's Decision. In view of a series of agreements and a consent order requiring the brokerage firm to modify its policies and procedures regarding the disclosure of revenue sharing agreements and payments, the trial court granted a motion by the brokerage firm to strike the request for injunctive relief, leaving the Attorney General to seek monetary relief only. The trial court ultimately granted the brokerage firm's motion to dismiss the Attorney General's complaint on the grounds that the Attorney General's suit sought to impose the State of California's view of what a mutual fund prospectus should say on funds that have shelf-space agreements with broker-dealers, and that the assertion of California's authority in this matter conflicted with exclusive federal regulation of information provided in mutual fund prospectuses flowing from the fact that, as registered investment companies, mutual funds are "covered securities" under NSMIA. NSMIA provides that "[e]xcept as otherwise provided in this section, no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof … shall directly or indirectly prohibit, limit, or impose any conditions upon the use of … with respect to a covered security … any offering document that is prepared by or on behalf of the issuer [of a covered security]."

The Appellate Court's Decision – NSMIA. After addressing various procedural questions, the Appellate Court reversed the trial court's decision on the merits, finding that the type of action brought by the Attorney General is expressly permitted by NSMIA under what is generally referred to as the statute's "savings clause," which expressly preserves state authority over certain matters in the face of the statute's assertions of exclusive federal authority. In particular, the Appellate Court noted that the statute provided that "[c]onsistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions." The Appellate Court found that the savings clause fell within the carveout in the statute's provision dealing with state regulation of offering documents ("[e]xcept as otherwise provided in this section,") and noted that as a consequence an enforcement action with respect to fraud or deceit, or unlawful conduct by a broker or dealer in connection with securities or securities transactions may limit the use of a mutual fund prospectus, notwithstanding the statute's prohibition against effecting such a limitation by other methods. The brokerage firm also made the argument that the Attorney General's suit should be dismissed because "[t]he alleged omissions complained of by [P]eople are not indicative of common law fraud or deceit by

a broker-dealer." The Appellate Court noted that nothing in NSMIA limits the savings clause to actions based on common law fraud or deceit and that the Attorney General's action unquestionably falls within the scope of the savings clause because at the very least the Attorney General's suit alleged "unlawful conduct by a broker or dealer" in alleging that the brokerage firm's conduct in selling and/or offering for sale the preferred mutual funds violated provisions of California law. The Appellate Court noted that its decision based on the plain statutory meaning of NSMIA was consistent with a decision earlier in 2007 by the Second Appellate Division of the California Court of Appeals with respect to a suit brought by the Attorney General against the distributor for a family of mutual funds and the affiliated adviser to the family of mutual funds regarding disclosure of revenue sharing arrangements with broker-dealers selling the funds' shares (as discussed in the February 6, 2007 *Alert*).

The Appellate Court's Decision – Rule 10b-10. On the issue of whether Rule 10b-10 pre-empts the Attorney General's suit, the Court looked to the preliminary note to the Rule which states that the Rule is not determinative of a broker-dealer's obligation under the general anti-fraud provisions of the federal securities laws to disclose additional information to a customer at the time of the customer's investment decision. (Rule 10b-10 prescribes certain information a broker must disclose to a customer when completing a securities transaction on the customer's behalf.) On this basis, the Appellate Court found that the Rule is not determinative of what information a broker-dealer must disclose in connection with a particular securities transaction, and therefore, does not conflict with the Attorney General's suit, *i.e.*, if the Attorney General prevails and obtains the monetary relief sought, this success will not stand as an obstacle to the accomplishment and execution of the full purposes and objectives of the SEC in enacting Rule 10b-10.

On the basis of the foregoing, the Appellate Court reversed the trial court's judgment and remanded the matter to the trial court.

➢ SEC Approves FINRA Rule Change Governing Sale of Deferred Variable Annuities

The SEC approved the adoption by Financial Industry Regulatory Authority ("FINRA," formerly the NASD) of a new rule governing sales practice standards and supervisory and training requirements applicable to transactions in deferred variable annuities. New NASD Rule 2821 applies to the purchase or exchange of a variable annuity contract and to a customer's initial subaccount allocations. It does not apply to subsequent payments or reallocations. Rule 2821 includes four primary requirements. First, in order to recommend the purchase or exchange of a deferred variable annuity, a member must have a reasonable basis to believe that the transaction is suitable. The rule sets forth specific factors to be considered and requires that the representative make reasonable efforts to obtain certain customer information. Second, the rule contains standards for principal review and requires principals to approve the transaction prior to transmitting the application to the insurance company (which must be within seven business days after the customer signs the application). Third, the rule requires members to establish and maintain supervisory procedures that are reasonably designed to achieve compliance with the rule. Fourth, the rule requires members to develop and implement training programs that are tailored to educate representatives and principals on the material features of deferred variable annuities and the requirements of the rule. The SEC also issued an exemptive order allowing FINRA members to hold customer funds for no more than seven business days while completing the required principal review.

According to the SEC release approving Rule 2821's adoption, FINRA will publish a Notice to Members announcing the effective date of the new rule no later than November 6, 2007, and the effective date of the new rule will be 120 days following publication of the Notice to Members (no later than March 5, 2008).

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Other Item of Note

➢ SEC Will Consider Final Joint Rules with FRB Exempting Banks from Definitions of "Broker" and "Dealer" under Exchange Act

The SEC announced that at its meeting scheduled for September 19, 2007, it will consider whether to adopt, jointly with the FRB, final rules implementing the Gramm-Leach-Bliley Act of 1999 provision that exempts banks from the definition of "broker" under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). At the meeting the SEC will also consider related rules exempting banks from the definition of "dealer" under the Exchange Act.