

Financial Services Alert

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In this issue:

Developments of Note

1. U.S. Supreme Court Upholds 2% Floor for Deduction of Investment Advisory Fees by Trusts
2. President Bush Issues Amendment to Executive Order Regarding National Security Reviews of Foreign Acquisitions of Control of U.S. Businesses
3. Hedge Fund Working Group Issues Best Practice Standards
4. OTS Expands Permissible Activities of Savings and Loan Holding Companies
5. SEC Staff Provides No-Action Relief to Allow Wholly-Owned Subsidiary of Registered Broker-Dealer to Succeed to Parent's Registration by Amendment to Parent's Form BD
6. OTS Approves Large Federal Savings Association's Establishment of and Investment in Foreign Service Corporations

Other Items of Note

7. Goodwin Procter to Host Webinar: "The Rise of ERISA Litigation Involving Collective Trusts and Other Retirement Products" - 2/7/2008 at Noon (Eastern Standard Time)
8. Federal Appeals Court Rules California Disclosure Requirements for Convenience Checks Preempted

Developments of Note

➤ **U.S. Supreme Court Upholds 2% Floor for Deduction of Investment Advisory Fees by Trusts**

The U.S. Supreme Court (the "Court" or the "Supreme Court") held that expenses incurred by trusts for investment advisory services are generally subject to the 2% floor for miscellaneous itemized deductions under Section 67(e) of the Internal Revenue Code (the "Code"). The ruling, in a case that has been closely watched by professional fiduciaries and investment advisers, is an important victory for the IRS. However, the Court did not adopt the approach to determining whether particular expenses are subject to the 2% floor put forward by the IRS in controversial proposed regulations issued in July 2007. The fiduciary and investment adviser community expects that the IRS will issue new proposed regulations incorporating the Court's approach. A number of experts have also predicted that, although the Court's ruling appears to resolve the issue, the result of the ruling may in fact be increased litigation, as fiduciaries attempt to apply the Court's analysis on a case-by-case basis.

Section 67(e) of the Code extends the 2% floor on miscellaneous deductions applicable to individuals to estates and non-grantor trusts, but makes an exception for the deduction of administration expenses "which would not have been incurred if the property were not held" in an estate or trust. Whether or not this exception applies to investment advisory fees incurred by a trust or estate has been disputed in a number of cases, and the U.S. Courts of Appeals were divided on the issue. The U.S. Court of Appeals for the Sixth Circuit, in *O'Neill v. Commissioner*, 994 F.2d 302 (6th Cir. 1993), held that the exception does apply, allowing trustees to fully deduct investment advisory fees in computing a trust's adjusted gross income. Both the Fourth and the Federal Circuits, however, have held that such fees are subject

to the 2% floor because individuals commonly incur similar expenses in relation to property held outside a trust.

The Supreme Court's ruling, which resolved the split among the circuit courts, resulted from *Rudkin Testamentary Trust v. Commissioner*, 467 F.3d 149 (2d Cir. 2006) ("*Rudkin*"), a case decided by the U.S. Court of Appeals for the Second Circuit. The trustee in *Rudkin* argued that his fiduciary duty under the state-law prudent investor standard required him to consult an investment adviser and that the adviser's fees were therefore caused by the fact that the property was held in a trust. The Second Circuit disagreed, interpreting Section 67(e) as allowing a full deduction only for trust expenses that could not (rather than would not, as Section 67(e) itself reads) have been incurred by individuals.

The trustee in *Rudkin* petitioned the Supreme Court to review the Second Circuit's decision and resolve the circuit split. In a unanimous opinion delivered by Chief Justice John Roberts, the Court rejected both the trustee's argument, noting that the prudent investor standard refers to a prudent individual investor, as well as the Second Circuit's approach, which it found inconsistent with the language of Section 67(e). Instead, the Court adopted the approach taken by the Federal and Fourth Circuits in *Mellon Bank, N.A., v. United States*, 265 F.3d 1275 (Fed. Cir. 2001), and *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003), which held that only expenses that are either not commonly or customarily incurred by individuals or unique to the administration of trusts are fully deductible and not subject to the 2% floor. "Since investment advice fees," Chief Justice Roberts wrote, "are not unique to the administration of a trust and are customarily also incurred by individuals, such costs incurred by a trust are deductible only in excess of the two-percent floor."

Chief Justice Roberts's opinion leaves a variety of open questions that fiduciaries and investment advisers will have to grapple with as they determine which costs of administering estates and non-grantor trusts are subject to the 2% floor. Most notably, the approach taken by the IRS in its proposed regulations (which were issued after the Supreme Court had agreed to hear the case, to the puzzlement of commentators) was based on the Second Circuit's more exacting approach and is expected to be withdrawn and replaced in a new set of proposed regulations. In addition, the Supreme Court, suggesting that its approach is more flexible than the Second Circuit's, indicated that the investment advisory fees incurred by a trustee might be fully deductible if an adviser imposes "a special, additional charge" only on fiduciary accounts or if a trust has an unusual investment objective or requires special balancing of the interests of various parties, "such that a reasonable comparison with individual investors would be improper." The Court did not address whether or how fiduciaries who provide investment as well as administrative services should unbundle investment and other fees, as required in the current set of proposed regulations.

➤ **President Bush Issues Amendment to Executive Order Regarding National Security Reviews of Foreign Acquisitions of Control of U.S. Businesses**

President Bush issued an amendment (the "Amendment") to Executive Order 11858 to provide procedures for implementation of the Foreign Investment and National Security Act of 2007 ("FINSAs"). FINSAs, effective on October 24, 2007, strengthened national security reviews of foreign acquisitions of control of U.S. businesses and authorized the President to take remedial actions as necessary to address any potential national security threats. FINSAs amended the requirements in Section 721 of the Defense Production Act of 1950 (the "Exon-Florio Statute"), under which, in recent years, the President has vetted foreign direct investments. The Amendment comes after a number of sovereign wealth funds, or government-controlled funds, agreed to take billion-dollar stakes in major U.S. financial institutions, such as Citigroup and Merrill Lynch.

The Amendment provides a detailed description of the operation of President Bush's delegatee, the inter-agency Committee on Foreign Investment in the United States ("CFIUS") and the process for review of foreign acquisitions. Among other things, the Amendment outlines more clearly the role of the director of national intelligence (the "DNI") in providing CFIUS with threat assessments posed by a foreign transaction involving a U.S. company and how CFIUS will keep Congress informed of its decisions. The Amendment also provides that CFIUS may impose conditions on a transaction to

address any potential national security risks after a threat analysis by the DNI, including the use of “mitigation agreements” designed to reduce national security risks as a condition for CFIUS or presidential approval. The order also enhances FINSA investigation requirements by requiring an investigation whenever any member of CFIUS believes that a transaction threatens national security. Regulations to carry out FINSA are still being written by the Treasury Department, as provided in the Amendment, and are expected to be finalized by the end of April.

➤ Hedge Fund Working Group Issues Best Practice Standards

The Hedge Fund Working Group (the “HFWG”), an organization of mainly London-based hedge fund managers organized in 2007, has issued a final report on best practice standards for hedge funds (the “Standards”). The report includes the Standards themselves, a summary of feedback received by the HFWG on a consultation paper published in October 2007 and a discussion of how the Standards are intended to be applied. The Standards are structured based on the principles of good business conduct promulgated by the UK’s Financial Services Authority (the “FSA”), which apply to investment managers subject to FSA regulation; the Standards have not, however, been passed on by FSA.

The Standards address the following topics:

- disclosure to investors and counterparties
 - investment policy and risks
 - fund terms (*e.g.*, fees and expenses, lock-up periods)
 - performance measurement
 - disclosure to lenders/prime brokers/dealers
- valuation
 - oversight, policies and procedures
 - segregation of valuation functions
 - hard-to-value assets
- risk management
 - oversight mechanisms
 - portfolio risk
 - liquidity risk
 - market risk
 - counterparty credit risk
 - control processes
 - disclosure
 - operational risk (governance and personnel, trading and execution, fraud and financial crime prevention, disaster recovery, model risk, IT security and legal and regulatory risk)
 - outsourcing risk
- fund governance
- shareholder conduct (including activism)
 - prevention of market abuse (*e.g.*, insider trading)
 - proxy voting
 - disclosure of derivative positions
 - borrowing stock to vote

It is envisioned that hedge fund managers will “sign up” to the Standards, and confirm each year that they continue to follow them. The firms that formed the HFWG are the initial signatories to the Standards. (Signatories are listed on the HFSB’s website.)

The Standards will be maintained by the Hedge Fund Standards Board (the "HFSB"). The members of the HFWSG and the chairman of the Alternative Investment Management Association Limited, a London-based trade association for hedge funds, managed futures and managed currency funds, currently serve as the HFSB's trustees. The HFSB will review the Standards on a rolling basis and maintain and develop them as industry conditions change. The HFSB's mandate includes considering best practice standards expected to be released by the President's Working Group on Hedge Fund Managers in the first quarter of 2008 and assessing the scope for convergence between the two sets of standards. The report indicates that the HFWSG has shared information and cooperated with the President's Working Group from the outset. The HFSB's website at www.HFSB.org includes additional information on the organization and its goals as well as materials for hedge fund managers who wish to become signatories to the Standards.

➤ OTS Expands Permissible Activities of Savings and Loan Holding Companies

The OTS amended its regulations to expand the permissible activities of savings and loan holding companies ("SLHCs"). Further, the OTS amended its regulations regarding the approval of certain acquisitions by SLHCs in order to conform the OTS regulations to the applicable statute. The amended regulations become effective on April 1, 2008.

The OTS revised its regulations to enable SLHCs to engage in activities that the FRB has permitted for bank holding companies ("BHCs") under section 4(c) of the Bank Holding Company Act of 1956, as amended (the "BHCA"). Under section 10(c)(2)(F)(i) of the Home Owners' Loan Act (the "HOLA"), SLHCs have the statutory authority to engage in such activities. The OTS stated that SLHCs, which propose to engage in activities permitted for BHCs under section 4(c) of the BHCA, must do so in accordance with the conditions set forth in the FRB's regulations for such activities. Further, SLHCs seeking to commence services or activities permissible for BHCs under the FRB regulations pursuant to section 4(c) of the BHCA must seek prior approval from the OTS unless (a) the SLHC seeking to commence the activity (i) received a rating of "satisfactory" or better prior to January 1, 2008 or a composite rating of "1" or "2" thereafter, in its most recent examination, (ii) is not in a "troubled condition" (as defined in 12 CFR §563.555), and (iii) is commencing the activity *de novo* or (b) the activity is permissible under some authority other than section 10(c)(2)(F)(i) of the HOLA.

In addition to expanding the permissible activities of SLHCs, the OTS also amended its regulations regarding certain acquisitions by SLHCs. Originally, under section 10(e)(1)(A)(iii) of the HOLA, SLHCs were prohibited, except in certain circumstances, from directly or indirectly acquiring more than 5% of the voting shares of a savings association that was not a subsidiary of the SLHC or more than 5% of the voting shares of another SLHC that was not a subsidiary of the acquiring SLHC. However, the American Homeownership and Economic Opportunity Act of 2000 amended section 10(e)(1)(A)(iii) to replace the prohibition of such acquisitions with a regulatory approval requirement. The OTS updated its regulations to reflect this approval requirement, making it consistent with the statute. Additionally, the OTS has also set forth approval standards for applications for acquisitions submitted under that provision.

➤ SEC Staff Provides No-Action Relief to Allow Wholly-Owned Subsidiary of Registered Broker-Dealer to Succeed to Parent's Registration by Amendment to Parent's Form BD

The staff of the SEC's Division of Trading and Management took a no-action position allowing a wholly-owned subsidiary that was succeeding to the business of its registered broker-dealer parent to also succeed to its parent's registration by amending the parent entity's Form BD, rather than having to apply for its own broker-dealer registration. The SEC staff's position reverses a prior interpretation provided to the parent entity in November 2007 that this succession would result in a change in control for purposes of Rule 15b1-3(b) of the Securities Exchange Act of 1934, as amended (the "1934 Act"), and therefore could not be effected by amendment to Form BD. (Rule 15b1-3(b) allows an unregistered entity to succeed to the business of a registered broker-dealer by amending the registered broker-dealer's registration on Form BD, provided the succession is based solely on a change in the registered broker-dealer's date or state of incorporation, form of organization or composition of a partnership.) As

the basis for its former view that the proposed succession would result in a change of control, the SEC staff had pointed to the fact that the direct shareholders of the broker-dealer after the succession (*i.e.*, the parent, the sole shareholder of its broker-dealer subsidiary) would be different from the direct shareholders of the broker-dealer prior to the succession (*i.e.*, the parent's shareholders). In granting the no-action relief, the SEC staff indicated that its revised position was based upon representations that: (1) the officers, directors and key management personnel of the subsidiary after the succession would be exactly the same as those of the parent entity; and (2) with no change in ownership or control, the parent entity's shareholders would become the indirect shareholders of the subsidiary. The SEC staff noted that its no-action position did not affect the registered broker-dealer's obligations as a member of a self-regulatory organization (*e.g.*, FINRA).

➤ **OTS Approves Large Federal Savings Association's Establishment of and Investment in Foreign Service Corporations**

The OTS issued an approval, OTS Order No. 2007-70 (the "Order"), in which it authorized a large federal savings association (the "Association") to establish and invest in several foreign service corporations (the "Foreign Service Corporations"). The OTS stated that HOLA and OTS regulations "neither explicitly prohibit, nor explicitly authorize federal savings associations to engage in foreign activities." The OTS concluded that where foreign activities are neither explicitly prohibited nor authorized a federal savings association ("FSA") can engage in such activities if they: (1) would be permissible if engaged in domestically; (2) can be conducted in a safe and sound manner; and (3) are incidental to the clearly permissible activities of the FSA.

The OTS found that the Association's proposal met each of these requirements. The proposed activities are permissible as they involve telemarketing, collection, service call and related traditional support for consumer and mortgage banking services. The foreign operations represented less than one-hundredth of one percent of the Association's total assets and the investment is within the Association's investment limits. Moreover, the OTS concluded that the Foreign Service Corporations' maintained corporate identities separate from the Association, as required by OTS regulations. Furthermore, the Order highlights that foreign operations raise certain safety and soundness concerns and that foreign operations "may become subject to new foreign regulatory requirements that may ultimately affect the Association's overall operation." Accordingly, to address these safety and soundness issues the OTS conditions its approval upon the OTS's (a) control over proposed changes in the type and size of the Foreign Service Corporations' activities; (b) access in the US to the Foreign Service Corporations' books and records; (c) jurisdiction over the foreign operations, including for examination, supervision and enforcement; and (d) ability to require termination of the foreign operations if the OTS determines there is undue risk.

Other Items of Note

➤ **Goodwin Procter to Host Webinar: "The Rise of ERISA Litigation Involving Collective Trusts and Other Retirement Products" - 2/7/2008 at Noon (Eastern Standard Time)**

As previously announced, Goodwin Procter will host a free 90 minute webinar at noon (EST) on February 7, 2008 that will address the recent waves of ERISA litigation and related regulatory investigations – particularly those involving collective trusts and allegations of excessive fees charged by service providers, in addition to "stock drop" cases (as discussed in the December 25, 2007 and January 1, 2008 *Alerts*).

To register, please click [here](#).

➤ **Federal Appeals Court Rules California Disclosure Requirements for Convenience Checks Preempted**

The Federal Court of Appeals for the Ninth Circuit ruled that California's disclosure requirements for "convenience checks" sent to credit card customers is preempted by the National Bank Act. In

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affirming the trial court's dismissal, the Court ruled that the California provision is expressly preempted by the National Bank Act's "incidental power" to "loan money on personal security." *Rose v. Chase Bank USA, NA*, 9th Cir. No. 05-56850, Jan. 23, 2008.