

# Financial Services Alert

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## *Developments of Note*

### ➤ **Federal District Court Dismisses Shareholder Suit Alleging Fund Board Breached Fiduciary Duty in Approving New Advisory Contract and Issued Misleading Proxy Materials to Shareholders Regarding Contract Approval**

The United States District Court for the Southern District of New York (the “Court”) dismissed claims brought by a shareholder of Citi New York Tax Free Reserve Fund (the “Fund”) against the Fund’s board of trustees regarding (i) the adoption of a successor advisory agreement entered into in connection with Citigroup’s sale of its asset management business and (ii) the proxy materials regarding shareholder approval of the successor advisory agreement. The Court’s decision, which dismissed the plaintiff’s claims in their entirety, addressed several novel issues under the Investment Company Act of 1940, as amended (the “1940 Act”) and Massachusetts’ corporation law.

*Background.* On June 23, 2005, Citigroup, Inc. entered into an agreement with Legg Mason, Inc. to sell substantially all of Citigroup’s asset management business to Legg Mason. Under the 1940 Act, the fact that the Citigroup advisory entities being sold would become Legg Mason affiliates meant that consummation of the transaction would cause the assignment of the Citigroup advisory entities’ advisory agreements with the Citigroup mutual funds, resulting in the advisory agreements’ automatic termination. The affected Citigroup mutual funds (including the Fund) therefore needed to enter into new advisory agreements with their respective investment advisers to be effective upon consummation of the Citigroup/Legg Mason transaction. Under Section 15 of the 1940 Act, the new advisory agreements had to be approved by each fund’s board and by its shareholders.

Certain Citigroup funds’ governing documents provided that, in the event of a shareholder vote, a procedure commonly known as “echo voting” or “proportional voting” would be available when certain

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kinds of intermediaries holding shares of record on behalf of the shares' beneficial owners did not receive voting instructions from the beneficial owners. Under this procedure, when a shareholder servicing agent (such as a bank or other financial institution) did not receive voting instructions from a customer, it could vote that customer's shares in the same proportions as the shares of those customers for which it did receive voting instructions. The proxy statement provided to fund shareholders in connection with their vote on the successor advisory agreements contained a discussion of echo voting and indicated that certain Citigroup affiliated shareholder servicing agents intended to use the procedure.

On May 30, 2006, following the approval of the new advisory agreements and the consummation of the Citigroup/Legg Mason transaction, a shareholder in the Fund filed a lawsuit against the Funds' independent trustees. The complaint alleged that the trustees had violated their fiduciary duties to shareholders by failing to extract additional concessions in the new advisory agreements or seek competitive bids from third parties. It also claimed that the use of echo voting by Citigroup affiliates serving as shareholder servicing agents was unlawful and that the proxy statement sent to shareholders was materially false and misleading because it did not disclose that fact.

*Business Judgment Rule Applies Where Demand Not Rejected Until After Lawsuit Filed.* Plaintiff framed his breach of fiduciary duty claim as a derivative action on behalf of the Fund. Because the Fund was organized as a series of a Massachusetts business trust, the Court viewed the substance of the derivative claim as being governed by Massachusetts corporation law. In 2003, Massachusetts substantially revised the requirements for bringing a derivative action against a Massachusetts corporation. Among other things, the Commonwealth instituted a "universal demand" rule, which prohibits a shareholder from asserting a derivative claim without first making a demand on the board of directors without exception. The shareholder is barred from bringing suit for 90 days after the demand, so as to give the board time to investigate and respond to the demand. If a majority of the independent directors vote to reject the demand in good faith after a reasonable inquiry, and the independent directors constitute a quorum, then the "business judgment" rule insulates their decision from review. If suit is filed after rejection of a demand, then the plaintiff must plead specific facts to show the directors were not independent, or failed to act in good faith or conduct a reasonable inquiry.

In this case, plaintiff made a presuit demand, and the independent trustees of the Fund retained counsel and undertook an extensive investigation into the plaintiff's allegations, and ultimately determined that the actions demanded by the plaintiff would not be in the Fund's best interests. The investigation was not yet complete when plaintiff filed suit, however. Plaintiff argued that the independent trustees' failure to complete their investigation within 90 days meant that they lost the protection of the business judgment rule under the statute. After examining the 2003 statute's legislative history, however, the court concluded that the Massachusetts legislature could not have intended that the timing of the plaintiff's filing suit should foreclose the independent trustees from availing themselves of the business judgment rule's protections in rejecting the demand. Since the plaintiff failed to plead or proffer any reasons why the rejection of his demand was improper, the derivative allegations were dismissed.

*No Private Right of Action Under Section 20(a) of the 1940 Act.* Plaintiff's second cause of action was based on Section 20(a) of the 1940 Act, which makes it unlawful to solicit proxies for a registered investment company in violation of such rules as the SEC may deem necessary or appropriate in the public interest or for the protection of investors. Rule 20a-1 under the 1940 Act, adopted pursuant to Section 20(a), subjects registered investment companies to the proxy rules under the Securities Exchange Act of 1934, as amended, including Rule 14a-9, which prohibits false or misleading statements in proxy statements. Although the Supreme Court recognized a private right of action under Rule 14a-9 in *J.I. Case Co. v. Borak* (1964), it subsequently disavowed the reasoning of *Borak* in *Alexander v. Sandoval* (2000). Since *Sandoval*, no court has ever addressed whether a private right of action exists under Section 20(a). The Court followed *Sandoval* and the Second Circuit's decision in *Olmstead v. Pruco Life Insurance Co.* (2002) and concluded that no private right of action exists under Section 20(a).

*Derivative Claims Were Improperly Pleaded as Direct Claims.* The Court also concluded that plaintiff's claims of proxy statement and common law misrepresentation were improperly pleaded as direct claims. The Court explained that because plaintiff had not alleged an injury separate and distinct from that suffered by shareholders generally or a wrong involving a contractual right as a shareholder, his claims were derivative in nature under Massachusetts law. Since plaintiff failed to make any demand with respect to these claims, the Court found that dismissal was required under Massachusetts law. Plaintiff argued that his claims were direct because the echo voting procedure amounted to an interference with his voting rights. The Court, however, rejected this argument, noting that the echo voting procedure was expressly authorized by the Fund's governing documents and that all shareholders had a right to vote for or against the new advisory agreements.

Having found for the Fund's independent trustees on each of the plaintiff's claims the Court dismissed the suit.

*Halebian v. Berv, No. 06 Civ 4099 (NRB), 2007 WL 2191819 (S.D.N.Y. July 31, 2007).* Goodwin Procter LLP represented the Fund's independent trustees in this matter.

### ➤ **FRB Grants Regulation W Exemption for Bank Transactions with Affiliated Broker-Dealers**

The FRB published a pair of substantially identical interpretive letters granting Regulation W affiliate transaction exemptions to specified arrangements between banks and their affiliated broker-dealers ("BDs") designed to extend credit to market participants to finance their holdings of mortgage loans and related assets (the "Assets"). In each case, the banks would enter into reverse repurchase agreements or securities borrowing transactions (collectively, "securities finance transactions" or "SFTs") with their affiliated BD, and the BD would contemporaneously enter into mirror SFTs with unaffiliated market participants. For each SFT, the bank would be overcollateralized, with the extent of the overcollateralization depending upon the types of assets offered as collateral. Moreover, to protect the bank from the insolvency of its affiliated BD, the parent of the bank would guarantee the BD's performance, and the SFTs between the bank and the BD must qualify as "securities contracts" under the Bankruptcy Code, and thus be promptly collectable in the event of bankruptcy. Under these circumstances, the FRB permitted each bank to enter into these covered transactions with its affiliated BD in an amount equal to almost 30% of the bank's total regulatory capital (almost three times the amount permitted by Regulation W). The letters provide that this exemption is temporary. The exemption would be available only for SFTs initiated during the period that the FRB's special discount window lending facility is available. In justifying the exemption, each letter states that the FRB is permitted to grant exemptions from Regulation W to provide public benefits, and the exemption would enable the banks to provide substantial liquidity to the markets with respect to the Assets.

### ➤ **SEC Solicits Comment on Discussion Paper by Chairman of Advisory Committee on Improvements to Financial Reporting**

The SEC Advisory Committee on Improvements to Financial Reporting (the "Committee") is soliciting public comment on a discussion paper prepared by its Chairman, Robert Pozen, that reviews the Committee's goals and the various areas of inquiry specified in the Committee's charter. The Committee's charter provides that its objective is to examine the US financial reporting system with a view to providing specific recommendations as to how to reduce unnecessary complexity in the system and how the system could be made more useful to investors. The discussion paper overviews the needs of different groups involved with the financial reporting system, both at the primary level (preparers and users) and at the secondary level (those who opine on financial information and those who regulate the financial reporting system). It also notes where the goals and needs of these different groups may conflict.

The discussion paper indicates that the Committee will use sub-committees to address specific topic areas and suggests the following as preliminary topics for the sub-committees' consideration:

- The causes and impact of complexity on financial accounting and reporting standards
- The current process for setting financial reporting standards
- The current process of regulating compliance with accounting and financial reporting standards
- The current system for delivering financial information to investors and otherwise providing access to that information
- International financial reporting standards, standard setting and regulation

At the conclusion of its work, the Committee will provide recommendations to the SEC Chairman on how to improve the US financial reporting system. Public comment is requested on any aspect of the discussion paper, as well as on other matters relating to the Committee's work. Comments must be received on or before September 24, 2007.

### ➤ FFIEC Releases Updated BSA / AML Examination Manual

The Federal Financial Institutions Examination Council ("FFIEC") released a revised 2007 version of its Bank Secrecy Act / Anti-Money Laundering ("BSA/AML") Examination Manual (the "Revised Manual"). The FRB, FDIC, OCC, OTS, NCUA, FinCEN and the Conference of State Bank Supervisors (with input from OFAC on applicable sections) collaborated on updating the Revised Manual. The revisions also reflect comments from the banking industry and bank examination staff.

The FFIEC stated that certain of the more significant updates reflected in the Revised Manual include discussions of: (1) regulatory expectations with respect to customer due diligence of lower-risk and higher-risk customers; (2) maintaining accounts and supporting documentation related to suspicious activity reports; (3) enhanced due diligence requirements and risk mitigation with regard to correspondent accounts of certain foreign banks; (4) remote deposit capture; (5) OFAC screening in connection with automated clearing house transactions; and (6) regulatory expectations and risk mitigation practices concerning trade finance.

### ➤ SEC Staff Grants No-Action Relief Broadening Spousal Joint Investment Possibilities in 3(c)(7) Funds

The staff of the SEC's Division of Investment Management granted no-action relief to permit funds that rely on the exclusion from the definition of "investment company" provided by Section 3(c)(7) ("3(c)(7) Funds") of the Investment Company Act of 1940, as amended (the "1940 Act"), to treat a trustee of a number of family trusts and his spouse, who propose to make joint investments in 3(c)(7) Funds, as "qualified purchasers" under Section 2(a)(51)(A) of the 1940 Act, *i.e.*, persons eligible to invest in 3(c)(7) Funds, based on the fact that the trustee exercises investment discretion over more than \$25 million in investments eligible to be considered in determining qualified purchaser status ("qualifying investments"), which are held by the family trusts. The trustee's investment discretion over these qualifying investments brings him within the category of persons that are qualified purchasers under Section 2(a)(51)(A)(iv) of the 1940 Act because (a) they are not formed for the purpose of acquiring interests in a 3(c)(7) Fund, and (b) in the aggregate they own and invest on a discretionary basis, not less than \$25 million in qualifying investments, either acting for their own account or the accounts of other qualified purchasers. Because neither the trustee nor his spouse falls within the category of qualified purchaser defined as persons owning \$5 million or more in qualifying investments, they are unable to take advantage of Rule 2a51-1(g)(2) under the 1940 Act which, in general terms, allows spouses investing jointly each to be evaluated for qualified purchaser status based on their aggregate ownership of qualifying investments regardless of the spouse that owns them. (The trustee's oversight of the family trusts' investments does not give him ownership of those investments for purposes of determining his qualified purchaser status.) In addition, because neither the trustee nor his spouse falls within certain categories of fund insider known as "knowledgeable employees" (as defined in Rule 3c-5 under the 1940 Act), they may not rely on a no-action position based on Rule 2a51-1(g)(2) that allows a knowledgeable employee (referred to by the SEC staff as a "deemed

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qualified purchaser”) and the knowledgeable employee’s spouse to invest jointly in a 3(c)(7) Fund even if the spouse is not a qualified purchaser or a knowledgeable employee. The SEC staff agreed that the rationale for permitting joint spousal investments under Rule 2a51-1(g)(2) and under the foregoing no-action position applied with equal force in the situation where one spouse was a qualified purchaser under Section 2(a)(51)(A)(iv) based on the exercise of investment discretion over (as opposed to the ownership of) qualifying investments.

### ➤ **CFA Institute Issues Guidance Statement on GIPS Recordkeeping Requirements and Publishes Q&A on GIPS Standards**

CFA Institute (formerly AIMR), the global membership organization that awards the CFA and CIPM designations issued guidance (the “Guidance Statement”) addressing the records necessary to satisfy the recordkeeping requirements of its Global Investment Performance Standards (“GIPS”). (GIPS is a set of ethical principals designed to be used by investment management firms in order to establish a globally standardized, industry-wide approach to creating performance presentations that communicate investment results to prospective clients.) The Guidance Statement indicates that it does not identify any additional specific records or documents that must be maintained, but nevertheless encourages firms to evaluate their historical documentation in light of the Guidance Statement. The Guidance Statement’s compliance date is October 31, 2007, but firms may (and are encouraged by the Guidance Statement to) apply the Guidance Statement before then.

CFA Institute also published answers to questions on a wide range of topics received at the 2006 Annual GIPS Conference. The topics covered in the Q&A are marketing, advertising, supplemental information, calculation methodology, benchmarks, composites, verification, dispersion, hypothetical/model performance, gaps in performance, fees, errors, significant cash flows, records, GIPS compliance dates, discretionary accounts, total firm assets, withholding taxes, mergers and acquisitions, performance portability, carve-outs, governance, leverage and wrap/SMA portfolios.

### *Other Item of Note*

### ➤ **SEC Issues Concept Release on Allowing US Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards**

The SEC published a concept release designed to elicit information about the extent and nature of the public’s interest in allowing US issuers, including registered investment companies, to prepare financial statements in accordance with International Financial Reporting Standards as published by the International Accounting Standards Board for purposes of complying with the SEC’s rules and regulations. Comments should be submitted on or before November 13, 2007.