

Financial Services Alert

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Developments of Note

➤ **FINRA Fines Broker-Dealer for Improper Soft Dollar, Hedge Fund Marketing and Compensation Activities**

FINRA announced that it had fined a broker-dealer operating a hedge fund services business \$450,000 for failing to adopt adequate supervisory procedures for its soft dollar and other activities related to its hedge fund clients. FINRA found that the broker-dealer's inadequate procedures allowed it to make \$325,000 in soft dollar payments to a hedge fund manager without reasonable inquiry into red flags raised by the invoice the manager had submitted to the broker-dealer. The invoice requested that the broker-dealer issue one check for \$75,000 to an individual for "consulting services" and a second check for just under \$250,000 to the manager for "research expense reimbursement." FINRA noted the following red flags raised by the invoice: It requested that the broker-dealer pay the manager directly for expenses that had purportedly been provided by a third party; the invoice did not describe what research had been provided to the manager or who had provided the research; and the invoice failed to describe the "consulting services" the individual provided. In addition, the hedge fund manager did not provide the broker-dealer with any invoice or back-up documentation from the individual consultant or from any research provider to support the invoice. FINRA characterized the invoice as "suspect on its face."

The other supervisory failures cited by FINRA included allowing the drafting and distribution of hedge fund sales materials that did not adequately disclose material investment risks to potential hedge fund investors. These sales materials were not approved by a registered principal, and were not properly recorded and maintained in the broker-dealer's files, as required by FINRA rules.

FINRA also found that the broker-dealer entered into an improper compensation arrangement with two of its brokers who also managed a hedge fund, allowing them to receive bonuses paid from a "profit pool" derived in part from commissions received by the broker-dealer on trading by their fund, contrary

to representations made to investors in the fund's offering documents and a separate agreement among the broker-dealer, the brokers and an outside firm that marketed the hedge fund. FINRA imposed a \$100,000 fine and 20 day suspension on each of the two brokers.

Among its other findings, FINRA determined that the broker-dealer failed to retain and preserve certain of its employees' e-mails and instant messages between January 2003 and December 2004, as required by federal securities laws and FINRA rules, and that this failure hampered FINRA's ability to investigate the firm's activities.

➤ **FDIC Issues Notice of Proposed Rulemaking Regarding Determination of Insured Deposit Balances of Failed Insured Depository Institutions; Special Provisions Address Large Bank Failures**

The FDIC issued a notice of proposed rulemaking (the "NPR") with two parts. Part 1 proposes a rule, applicable to all insured depository institutions ("DIs" and each a "DI"), that would govern how and at what point in time deposit account balances would be determined when a DI fails. Part 2 of the NPR proposes requirements to help determine the insurance status of depositors of large DIs that fail. The NPR defines a "Large DI" as one that has at least \$2 billion in domestic deposits and either (1) more than 250,000 deposit accounts or (2) total assets that exceed \$20 billion, without regard to the number of deposit accounts. The NPR is the third FDIC issuance on this subject. The FDIC issued advanced notices of proposed rulemaking (the "ANPRs") in 2005 and 2006, and the NPR reflects certain of the comments that the FDIC received in response to the ANPRs.

Part 1. Part 1 of the NPR defines deposit account balance on the day a DI fails as the end-of-day ledger balance of the deposit on the day of failure. This is the amount on which the FDIC would make insurance determinations. In determining whether a deposit account transaction is on the DI's ledger at the end of the day, the FDIC will establish an FDIC Cutoff Point (a point of time after the FDIC takes control of the DI as receiver). The FDIC Cutoff Point will be used to determine ledger balances unless the DI's ordinary cutoff time on the date of failure for a specific type of transaction is earlier than the FDIC Cutoff Point--in that event, for that category of transactions, the DI's cutoff time will be used.

Under the NPR, the FDIC will take steps to prevent funds from being received by or removed from the failed DI. These steps can include suspension of wire activities and preventing the establishment of new deposit accounts at the DI.

With respect to sweep accounts, the NPR provides that the FDIC, in determining the insured deposit account balance, will complete a prearranged "internal sweep" on the day of failure of a DI, if the applicable sweep account agreement provides for the automated sweep after transactions are posted for the day, but before the final deposit account balance is established. Internal sweeps are those that sweep funds within the DI by accounting or bookkeeping entries. For external sweeps (those where funds are moved outside of the DI, such as to a money market mutual fund), the status of the swept amount on the day the DI fails depends upon whether the funds left the DI by wire or otherwise before the FDIC Cutoff Point. If at the time of the FDIC Cutoff Point the funds had not been swept outside of the customer's deposit account at the DI (or were being held by the DI temporarily in an omnibus account at the DI), then the funds would be counted as insured deposits. If the funds had been swept into the external sweep investment vehicle at the time of the FDIC Cutoff Point, they would not be insured deposits, but would be an investment that "typically would not be subject to loss in the event of [the DI's] failure."

Part 2. The provisions of Part 2 of the NPR are intended to allow the deposit operations of a failed Large DI to be continued on the day following the failure. The FDIC states that as of June 30, 2007, there were 159 Large DIs.

The NPR requires a Large DI to modify its deposit systems and adopt and implement procedures that would, in the event it fails, (1) allow automatic posting of provisional holds on large deposit accounts in

any percentage specified by the FDIC on the day the DI fails; (2) provide deposit account data to the FDIC in a standard format; and (3) allow automatic removal of the provisional holds and posting of the results of insurance determinations as specified by the FDIC.

The FDIC states that implementation of Part 2 of the NPR will provide prompt liquidity to depositors of failed Large DIs, enhance market discipline, ensure equitable treatment of depositors at different Large DIs and help preserve the franchise value of a failed Large DI (reducing FDIC costs).

Public comments on the NPR are due to the FDIC by April 14, 2008.

➤ **FINRA Proposes to Eliminate Principal Pre-Approval Requirement for Sales Material Previously Filed by Another Member**

FINRA has proposed amendments to NASD Rule 2210 that would create an exception from the principal pre-approval requirements for certain sales materials. Under the current requirements, a registered principal of a FINRA member firm must give written approval to advertisements, sales literature and independently prepared reprints (collectively, “sales material”), prior to their use. The proposed amendments would create an exception to Rule 2210’s registered principal pre-approval requirements allowing a member firm to use sales material without principal pre-approval, if another firm had filed the sales material and received a letter from FINRA stating that the sales material appears consistent with applicable standards. A firm relying on the exception could not materially alter the sales material or use it in a manner inconsistent with any conditions in FINRA’s review letter.

Although FINRA expects that the exception would be relied on primarily by intermediaries with respect to mutual fund and variable insurance product sales materials prepared by those products’ underwriters, it would be available for sales material for other products, such as REITs or direct participation programs, that also meet the exception’s requirements. Under the proposed rule amendments, a firm could continue to review sales material received from other firms even if the exception were available. The proposed amendments would not affect existing contractual obligations between underwriters and intermediary firms, which may, for example, prohibit an underwriter from sending sales material directly to an intermediary’s representatives.

The proposed amendments would make a related change to the sales materials recordkeeping requirements so that a firm relying on the principal pre-approval exception would have to maintain a record of the name of the firm that filed the sales material and a copy of the related FINRA review letter. Unrelated to the principal pre-approval exception, the proposed amendments would codify existing practice that the recordkeeping requirement for sales material apply beginning with the date of first use. The SEC release announcing the proposed amendments indicates that FINRA will announce the effective date of the amendments in a *Regulatory Notice* that will be published no later than 60 days after SEC approval. Comments on the proposed amendments are due by January 18, 2008.

➤ **Federal District Court Holds That Savings and Loan Holding Company Act Does Not Provide for Private Right of Action; Dismisses Suit Brought by State-Chartered Mutual Savings Association Alleging Unlawful Takeover Tactics**

The United States District Court for the District of New Jersey (the “District Court”) held that the Savings and Loan Holding Company Act, 12 U.S.C. § 1467a (the “Act”) does not contain an implied private right of action, and dismissed a complaint brought by a state-chartered mutual savings association alleging violations of the Act. Spencer Bank, S.L.A. (the “Bank”) brought suit claiming that the defendants, Lawrence B. Seidman and his associates, unlawfully attempted to influence the Bank’s board of directors and gain a position on the Bank’s board to force a mutual to stock conversion and later sale or merger, in violation of the Act. The Bank also alleged that the defendants engaged in an unlawful pattern of aggressive tactics to take over targeted financial institutions, and consisted of a “company” within the meaning of the Act because together they held beneficial ownership of at least ten percent of the voting shares and were one of the two largest shareholders of the targeted institutions.

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After determining that the Act did not expressly provide a private right of action, the District Court explained that congressional intent was the key for determining whether there was an implied private right of action that would grant the Bank a federal right to bring suit. The District Court first determined that while the Act did benefit mutual savings associations, it was not enacted for their “especial benefit” such that it created a federal right of action in favor of a mutual savings association. The District Court then determined that the language of the statute and its legislative history clearly demonstrate a “singular” purpose to provide a framework for regulation of savings and loan holding companies, which framework granted enforcement powers to the OTS and provided for civil and criminal penalties “to enable the [OTS] to enforce the provisions” of the Act.

Five banking associations submitted position papers or memoranda in support of the plaintiff’s argument for a private right of action. The District Court also received a letter from the OTS stating that, “OTS believes strongly in the mutual form of organization and is a proponent of mutuality,” but declining to express any further opinions on the issues on the grounds that the agency was not fully informed as to the underlying facts of the case. *Spencer Bank, S.L.A. v. Seidman*, Civ. No. 07-1337 (D.N.J., January 3, 2008).

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](#).

➤ SEC and FINRA Announce Opening of Registration for CCO Outreach BD National Seminar

The SEC and FINRA announced the opening of registration for the inaugural *CC Outreach BD National Seminar* for broker-dealer chief compliance officers (CCOs), which will be held on March 7, 2008 at SEC headquarters in Washington, D.C. The seminar will include panel discussions with SEC and FINRA staff and CCO representatives from both large and small broker-dealers about the latest compliance developments relevant to CCOs. The national seminar will be followed by a series of regional seminars held by SEC and FINRA staff, whose dates and locations have not yet been announced. The National Seminar agenda and registration information are available at <http://www.sec.gov/info/bdccooutreach.htm> and <http://www.finra.org/bdccooutreach>. (For more on the CCO Outreach BD program, which is modeled after the ongoing CCO Outreach Program for the CCOs of registered investment advisers and registered investment companies, see the November 6, 2007 *Alert*.)