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Developments of Note

¾ U.S. Supreme Courts Holds that Preemption of State Laws Extends to National Bank Operating Subsidiaries

On April 17, 2007, the Supreme Court of the United States, in *Watters v. Wachovia Bank, N.A. et al.*, 550 U.S.C. __ (2007), upheld, by a 5-3 majority, a Sixth Circuit Court of Appeals decision and ruled that a national bank's mortgage business, whether conducted by the bank itself or through a

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In focusing on national bank powers, the Court distinguished operating subsidiaries from financial subsidiaries, which were authorized under the Gramm-Leach-Bliley Act of 1999 and which, unlike operating subsidiaries, can engage in certain activities not permitted to the parent national bank. Although not directly so stating, the Court's analysis suggests that financial subsidiaries will not necessarily enjoy the same benefit of preemption as operating subsidiaries.

The federal bank regulators quickly issued press releases supporting the Court's decision. The Office of the Comptroller of the Currency stated that:

> "We are pleased that the Court's decision supports the ability of national banks to continue to conduct business activities in their operating subsidiaries as they are now doing. We will continue to supervise national banks and their subsidiaries to assure that their customers are treated fairly and receive the strong protections available under federal laws and regulations."

Director John Reich of the Office of Thrift Supervision stated that, "today's decision is consistent with the Court's decision in 1982, in *Fidelity Federal Savings and Loan Assn. v. De la Cuesta*, in which the Court then recognized the ability of federal thrifts to operate under nationwide standards administered exclusively by the OTS."

¾ SEC Commissioner Nazareth Discusses Next Steps in Mutual Fund Regulation

In a speech delivered at the Mutual Fund Directors Forum 7th Annual Policy Conference, SEC Commissioner Annette L. Nazareth discussed further steps in enhancing mutual fund disclosure and assisting independent directors in constraining fund costs that she hopes the SEC will address in the future. After providing an overview of past SEC initiatives in the area of mutual fund governance and disclosure, Ms. Nazareth indicated that she hoped the SEC would be able to consider further reform of the mutual fund disclosure framework in the near future. She noted that the SEC staff is currently working on an initiative that would allow mutual fund investors to receive a streamlined, short form disclosure document, with a more detailed document available on the internet or delivered in paper upon request. The streamlined document could include key information designed to inform investment decisions, such as fees and expenses, risks, investment objectives and strategies, and historical returns. Ms. Nazareth emphasized that disclosure reform is necessary to improve the transparency of fund costs for investors. She stated that this reform should produce a disclosure document that prospective investors could use when they make investment decisions, unlike the current prospectus which she believes does not serve investors well. In addition, she stated that the SEC should revisit its point of sale disclosure proposal (see the March 8, 2005 and February 3, 2004 *Alerts*) in conjunction with mutual fund disclosure reform and consider whether broker-dealers should also be required to provide a streamlined mutual fund disclosure document, in addition to the broker-specific cost and conflict information currently reflected in the proposal, to prospective investors at the point of sale. Ms. Nazareth also addressed the issue of transparency of mutual fund costs, indicating that the SEC should examine 12b-1 fees and at a minimum, determine whether distribution costs for mutual funds should be priced more explicitly. She noted that investors do not appear to understand the nature or extent of these charges and suggested that explicit pricing of distribution expenses would make investors more sensitive to them and impose more market discipline on the process.

Ms. Nazareth also suggested that the SEC should consider asking Congress to amend Section 22(d) of the Investment Company Act of 1940, as amended (the "1940 Act"), to end mandatory retail price maintenance. (Section 22(d) prohibits a registered investment company (a "fund") and any principal underwriter or dealer in the fund's shares from selling those shares except at the current public offering price described in the fund's prospectus. Rule 22d-1 under the 1940 Act permits scheduled variations in, or elimination of, a fund's sales load subject to certain disclosure requirements.) She observed that, among other things, it appears that developments in the industry since 1940 have eliminated the rationales for this provision. She observed that riskless trading by fund insiders to the dilution of other shareholders was eliminated with Rule 22c-1 under the 1940 Act and "forward" pricing. She further stated that eliminating mandatory retail price maintenance would have a positive effect on mutual fund

costs, as it would introduce price competition among dealers. Ms. Nazareth went on to say that after taking these steps the SEC should evaluate their impact on mutual fund fees and expenses, and if they have not achieved the desired results, look to further structural or other possible responses.

¾ OCC Issues Letter Concluding that National Banks May Make Non-Controlling Investments in LLC Engaging in Fraud Prevention, Identity Verification and Related Activities

The OCC issued an interpretive letter ("Letter 1077") in which it concluded that four national banks (the "Banks") may make non-controlling equity investments in a limited liability company (the "LLC") organized to sell fraud prevention, identity verification, credential validation and payment/deposit risk services to financial institutions, credit card issuers, check acceptance companies, brokerage firms, mutual fund companies, retailers, government agencies and others. Each of the Banks owns 18% of the membership interests in the LLC.

The OCC concluded in Letter 1077 that the Banks' non-controlling investments in the LLC are permissible under 12 U.S.C. §24 (Seventh) because they satisfy each of the four criteria, described below, that the OCC has traditionally used in its evaluation of non-controlling investments by national banks.

1. *The LLC's activities are part of or incidental to the business of banking*. The OCC stated that identity verification, credit fraud detection, fraud prevention and credential validation services are all within the scope of the business of banking.

2. *The Banks must be able to prevent the LLC from engaging in activities not permissible for national banks.* Each of the Banks has represented that the LLC's activities will be limited to those permissible for national banks. Moreover, the Banks have sufficient seats on the LLC's Management Committee to ensure that this commitment is honored. Furthermore, the LLC Agreement has a provision limiting the LLC's activities to those permissible for national banks and the provision may not be amended without the unanimous consent of the Banks.

3. *The Banks' loss exposure must be limited.* As a legal matter, the Banks' loss exposure is limited by statute because an investor in a limited liability company does not incur liabilities or obligations of the limited liability company solely by reason of being a member or manager of such company. As an accounting matter, the Banks' respective 18% investments will be accounted for as an equity investment and accordingly the Banks' accounting liability will be limited to the amount of their respective investment.

4. *The investment must be useful to the Banks in their banking business and not mere passive investments.* The OCC found that the LLC's activities are "not just convenient and useful, but essential to the Banks' business" and that the investments are more than passive investments.

Finally, the OCC concluded that the Banks have the systems and controls and the general capacity to conduct the activity through the investment in the LLC in compliance with applicable law and in a safe and sound manner.

¾ FDIC Issues Supervisory Policy on Identity Theft

The FDIC issued a Supervisory Policy on Identity Theft (the "Policy"; FIL – 32-2007). The Policy defines identity theft as "fraud committed or attempted by using the identifying information of another person without his or her authority." The Policy first describes the characteristics of identity theft, the majority of which, states the FDIC, is committed using hard copy identification, with a smaller amount being committed electronically using phishing, spyware, hacking and computer viruses. The FDIC states that it expects nonmember banks ("Banks") to take steps to "detect and prevent identity theft and mitigate its effects in order to protect consumers and help ensure [Banks'] safe and sound operations."

The FDIC states that one key element of identity theft prevention is the establishment by Banks of the written program, required by the FDIC, to safeguard customer information, and to properly dispose of consumer information. Another important component of the Bank's identity theft prevention program should be the use of strong and reliable methods to authenticate the identity of customers using the Bank's electronic banking systems. Furthermore, the Policy notes that if a Bank's systems have been compromised by an unauthorized party gaining access to customer information, the Bank will be expected to notify the affected Bank customers promptly.

The Policy next discusses FDIC examinations of identity theft related matters and notes that revised examination procedures for the Fair Credit Reporting Act ("FCRA"), used for reviews of consumer compliance, seek to verify that a Bank has complied with FCRA's fraud and active duty alert provisions. The Policy notes that consumer education is also an important element of combating identity theft as consumers must be trained to be diligent in protecting themselves from identity theft. In concluding, the FDIC states that it "treats the theft of personal financial information as a significant risk area [because it can] impact the safety and soundness of a [Bank], harm consumers and undermine confidence in the banking system and economy."

¾ Director of SEC's Division of Investment Management Discusses Regulatory Initiatives

In the keynote address at a recent investment management industry conference, Andrew J. Donohue, Director of the SEC's Division of Investment Management (the "Division"), discussed the initiatives currently being undertaken by the Division. He indicated that following the intense regulatory activity resulting from the late trading and market timing scandals in 2003, the Division had returned to a sufficient state of normalcy that it is able to assess its "regulatory inventory." As part of this process, Division is reviewing the regulations governing investment companies and investment advisers and considering which, if any, may need to be revised, updated or eliminated. He highlighted a program of active outreach to fund directors seeking their perspective on the regulatory framework for registered investment companies as an important part of this review. Mr. Donohue indicated that he personally was reaching out to fund directors by going to conferences fund directors attend and by attending fund board meetings.

Mr. Donohue identified the following five areas of particular regulatory focus for the Division going forward: disclosure reform (including interactive data), 401(k) investors, Rule 12b-1, books and records, and new products. He observed that the Division's disclosure reform initiative, which includes both prospectus disclosure reform and interactive data tagging, is a top priority for SEC Chairman Cox. Echoing remarks made by Commissioner Nazareth (discussed in an earlier article in this issue), Mr. Donohue indicated that the Division is preparing a proposal that would allow registered funds to offer their securities via a streamlined disclosure document to be delivered to investors electronically or on paper, while requiring more detailed information to be available on the internet or in paper form for delivery upon request. This streamlined disclosure document could include key information investors need to make informed decisions, such as fees and expenses, risks, investment objectives and strategies, and historical returns. He noted that the current profile prospectus is one model the Division is examining as it prepares this proposal. He expressed a personal preference for a two-page document covering only a single fund. Mr. Donohue added that the Division is also considering whether to update and streamline shareholder report requirements, for example, by allowing mutual funds to provide a streamlined report with more detailed information available via internet or in paper form upon request. Mr. Donohue added that, in conjunction with its disclosure initiative, the Division was working with Department of Labor to potentially extend the application of these reforms to disclosures made to 401(k) plan participants regarding the funds they hold or are considering holding. On the subject of interactive data tagging, Mr. Donohue indicated that, following the close of the public comment period on March 14, the Division had begun reviewing public comments received on its proposal to allow voluntary interactive data tagging of disclosure data in the risk/return summary of mutual fund prospectuses (as discussed in the February 6, 2007 *Alert*). He also discussed the Division's focus, in coordination with the Department of Labor, on expenses relating to 401(k) plan administration and issues related to revenue sharing and information provided to plan sponsors.

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Mr. Donohue observed that the primary use of 12b-1 fees has shifted from the limited marketing and advertising purposes originally envisioned at the time the Rule was adopted, to serving primarily as a substitute for a sales load or as a means of compensating brokers for servicing their clients. He stated that reconsidering Rule 12b-1, both the rule itself and the factors boards must consider in approving or renewing a Rule 12b-1 plan, is a top priority of the Division. Mr. Donohue indicated that the Division is currently undertaking a comprehensive review of the recordkeeping requirements for investment companies and investment advisers that entails analysis of the purposes behind each recordkeeping requirement, the means currently used by firms to maintain and update their records and available technologies, among other considerations.

In the area of new products, Mr. Donohue discussed recent activity involving exchange traded funds ("ETFs"), including the introduction of leveraged ETFs, ETFs based on affiliated indices and high-yield bond ETFs. Mr. Donohue noted that the Division was tracking the proliferation of yield-based investment products designed to appeal to investors in the distribution phase of their personal investment cycles. He emphasized that funds designed to appeal to these investors, and those selling the funds, must be clear about how yield is generated, whether the yield is from income, and the risks associated with a fund and its yield-generation techniques. Mr. Donohue concluded by reviewing concerns associated with increasing use by funds of derivatives and sophisticated financial instruments. He indicated that it was imperative that all relevant parts of a fund's operations team understand these types of portfolio instruments and appreciate their use and implications, not only the portfolio manager and investment officers involved in a decision to use an instrument, but also the legal, compliance and accounting groups. He expressed concern that many fund firms' systems, particularly their compliance systems, may not be sophisticated enough to effectively handle synthetic instruments.

¾OTS Proposes Revised SLHC Rating System

The OTS proposed revisions to its examination rating system for savings and loan holding companies ("SLHCs"), principally to further emphasize risk management. In this regard, while the proposed revision retains Capital, Organizational Structuring and Earnings as components of its composite rating, it replaces "Relationship" with "Risk Management." The Risk Management rating includes an assessment of 4 areas: (i) board and senior management oversight; (ii) policies, procedures and limits; (iii) risk monitoring and management information systems; and (iv) internal controls. Moreover, while the proposal retains the Organizational Structuring component, the focus is no longer simply on changes in organizational structure and affiliate activities. Instead, this component would focus on an assessment of risks in the holding company enterprise, with a particular focus on a number of defined risks, including: credit, market, liquidity, operations, legal/compliance, country/sovereign, contagion/systemic, concentration, intragroup transactions and strategic/execution.

In addition to changing certain components, the proposal would adopt a 5-point numeric scale similar to the system for commercial banks. Finally, while historically the OTS has based the rating of the holding company on its effect on its subsidiary thrift, the proposal would focus more on the holding company's overall financial condition, operations and risk profile. Comments on the proposal are due by June 8, 2007.

Other Item of Note

¾SEC Staff Announces Availability of Anti-Money Laundering Compliance Tool for Broker-Dealers

The SEC staff announced the availability of its "AML Source Tool" designed to assist broker-dealers in their anti-money laundering ("AML") compliance efforts. Originally developed by the SEC's Office of Compliance Inspections and Examinations for its examiners, the AML Source Tool compiles and organizes key AML laws, rules and related guidance applicable to broker-dealers, including hyperlinks to source materials. The AML Source Tool is available on the SEC website at http://www.sec.gov/about/offices/ocie/amlsourcetool.htm.