

Financial Services Alert

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In this issue:

Developments of Note

1. Retirement Plan Service Provider May be Liable for Breach of ERISA Fiduciary Duty In Cross-Selling Rollover IRAs Invested in Proprietary Mutual Funds
2. FRB Proposes Rules for Credit Card and Overdraft Services
3. DOL Provides Guidance on Default Investment Alternatives
4. OTS Approves Foreign Operating Subsidiary in India
5. OCC Issues Final Rule Reducing Regulatory Burden
6. OCC Issues Interpretive Letter Concerning Loans Made to Bank “Insiders”
7. OCC Issues Interpretive Letter Concerning Bank’s Ability to Hold Commercial Real Estate for a “Moment-In-Time”
8. New York, New Jersey and Pennsylvania Sign Interstate Regulation Pact

Other Items of Note

9. California Announces that it Will Not Proceed with Proposed Narrowing of Private Adviser Licensing Exemption
10. OCC Issues Payment Processors Risk Management Guidance

Developments of Note

➤ Retirement Plan Service Provider May be Liable for Breach of ERISA Fiduciary Duty In Cross-Selling Rollover IRAs Invested in Proprietary Mutual Funds

A federal district court in Iowa allowed class action claims to proceed against a financial services company for alleged breaches of fiduciary duty under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), resulting from the company encouraging retirement plan participants to roll over their 401(k) plan assets into IRAs invested in the company’s proprietary mutual funds.

Two former participants of plans serviced by the financial services company sued that company and its broker-dealer subsidiary (collectively, the “Company”) on behalf of a class of all participants of retirement plans who rolled over retirement plan assets into IRAs invested in funds sponsored by the Company in response to Company solicitations. Plaintiffs claimed that they each received a letter on the Company’s letterhead at the time of their retirement stating that “Immediate Action [was] Required” and that their change in employment required an adjustment in “retirement account status.” Following receipt of the letter, plaintiffs called the listed numbers and were allegedly convinced by Company employees to withdraw their 401(k) assets and move them into rollover IRAs investing in mutual funds sponsored by the Company. Plaintiffs allege that, as a result of this change, they paid higher fees and earned lower returns than if they had kept their retirement assets in their 401(k) accounts. The complaint alleges that the Company breached a range of fiduciary duties through its actions, including “deceiving and misleading plan participants about the nature of the advice being given,” misleading participants about the cost of the investment products, withholding information about the bonus structure for the Company’s sales associates, and misusing personal financial information for sales purposes.

While the court granted defendants' motion to dismiss plaintiffs' claims under Section 502(a)(2) of ERISA seeking recovery of losses to their 401(k) plan because their plans had not incurred any loss, the court denied defendants' motion to dismiss breach of fiduciary claims under Section 502(a)(3) of ERISA. The court held that standing under Section 502(a)(3) requires only that plaintiffs allege enough facts to state a claim that is plausible on its face that (i) defendants breached a fiduciary duty or violated the terms of a plan or ERISA, and (ii) that the breach caused the plaintiffs to leave the plan. The court held that plaintiffs met this standard, as they alleged generally that but for defendants' deceptions, misrepresentations, and omissions, plaintiffs would not have moved their funds out of their 401(k) plans. Although the court recognized the remedies available under Section 502(a)(3) are more limited than those available under Section 502(a)(2), it found that, if successful on the merits, plaintiffs may be entitled to disgorgement of the Company's profits and the right to transfer their accounts back into their 401(k) plans. (*Young v. Principal Financial Group*, ___ F. Supp. 2d. ___, No. 4:07-cv-00386, 2008 WL 1776590 (S.D. Iowa). This decision has potential implications for how financial service institutions cross-sell their products to ERISA plan participants. Courts will view the sales process through the lens of hindsight and often look critically at practices that have any appearance of impropriety. Each case is likely to turn on its particular facts and circumstances.

Goodwin Procter attorneys have been significantly involved in defending financial services companies in the recent wave of cases challenging the handling of retirement plan assets under ERISA. A transcript of a February 2008 webinar in which they discuss the issues these cases raise is available at <http://www.goodwinprocter.com/NewsEvents/Webinars/TheRiseofERISALitigationInvolvingCollactiveTrustsandOtherRetirementProducts.aspx>.

➤ FRB Proposes Rules for Credit Card and Overdraft Services

The FRB proposed rules regarding credit cards and overdraft services. The proposals would amend Regulations AA (Unfair Acts or Practices), Z (Truth in Lending) and DD (Truth in Savings). The unfair acts or practices proposal is a joint proposal of the FRB, OTS and NCUA.

Regulation AA

Regulation AA would be amended to prohibit certain acts or practices by banks in connection with credit card accounts and overdraft services for deposit accounts.

Credit Cards

Time to Make Payments. Banks would be prohibited from treating a payment as late unless the consumer has been provided a reasonable amount of time to make that payment. There would be a safe harbor for banks that send periodic statements at least 21 days prior to the payment due date.

Allocation of Payments. When different APRs apply to different balances on a credit card account (for example, purchases and cash advances), banks would have to allocate payments exceeding the minimum payment using one of three methods or a method equally beneficial to consumers. They could not allocate the entire amount to the balance with the lowest rate. A bank could, for example, split the amount equally between two balances. In addition, to enable consumers to receive the full benefit of discounted promotional rates (for example, on balance transfers), during the promotional period payments in excess of the minimum would have to be allocated first to balances on which the rate is not discounted.

Applying Rate Increases to Existing Balances. Banks would be prohibited from increasing the interest rate on outstanding balances unless the increase is due to: (1) the operation of an index; (2) the expiration or loss of a promotional rate (provided the rate is not increased to a penalty rate); or (3) the minimum payment not being received within 30 days of the due date.

Two-Cycle Billing. Banks would be prohibited from imposing finance charges based on balances on days in billing cycles preceding the most recent billing cycle.

Financing of Security Deposits and Fees. Banks would be prohibited from financing security deposits and fees for credit availability (such as account-opening fees or membership fees) if charges assessed during the first 12 months would exceed 50% of the initial credit limit. The proposal would also require financed security deposits and fees exceeding 25% of the initial credit limit to be spread over the first year.

Credit Card Holds. Banks would be prohibited from imposing a fee when the credit limit is exceeded solely because a hold was placed on available credit.

Firm Offers of Credit. The proposal would require banks making firm offers of credit advertising multiple APRs or credit limits to disclose the factors that determine whether a consumer will qualify for the lowest APR and highest credit limit advertised (for example, the consumer's credit history, income, and debts). A safe harbor disclosure is provided.

Overdraft Services

Right to Opt Out. Banks would be prohibited from imposing a fee for paying an overdraft unless the bank has provided the consumer with an opportunity to opt out of the payment of overdrafts and the consumer has not done so. The opt-out right would apply to all transaction types. Banks also would be required to provide consumers a partial opt-out for overdrafts resulting from ATM and point-of-sale transactions.

Debit Holds. Banks would be prohibited from imposing a fee when the account is overdrawn solely because a hold was placed on funds in the consumer's deposit account.

Regulation Z

The Regulation Z proposal would provide that mailed credit card payments received by 5 p.m. on the due date must be considered timely. In addition, if a creditor does not receive or accept mailed payments on the due date (for example, when the due date falls on a Sunday or holiday), a payment received by mail on the next business day would be considered timely.

Regulation DD

The Regulation DD proposal contains overdraft disclosure requirements, including:

Disclosure of Aggregate Overdraft Fees. Banks would be required to disclose on periodic statements the aggregate dollar amounts charged for overdraft fees and for returned item fees (for the month and the year-to-date). Currently, only banks that promote or advertise the payment of overdrafts must disclose aggregate amounts.

Disclosure of Balance Information. Banks that provide account balance information through an automated system would be required to disclose the amount of the consumer's funds available for immediate use or withdrawal, without including additional funds the bank may provide to cover overdrafts.

The comment period for the Regulation AA proposal ends 75 days after publication in the *Federal Register*; the Regulation Z and DD proposal have 60-day comment periods.

➤ DOL Provides Guidance on Default Investment Alternatives

The Department of Labor (the “DOL”) issued Field Assistance Bulletin 2008-03 under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), which provides DOL guidance concerning a safe harbor for ERISA plan fiduciaries who invest the assets of participants in a participant-directed defined contribution plan subject to ERISA (a “Plan”) in a qualified default investment alternative (a “QDIA”) and meet certain conditions. The DOL also made certain technical corrections to the final QDIA regulation (see the October 30, 2007 *Alert*). Specifically, the DOL:

- corrected the “grandfather” relief for stable value funds by revising the definition of stable value fund. Under the corrected definition, a stable value fund is an investment product or fund that (i) is designed to preserve principal, (ii) provides a rate of return generally consistent with that earned on intermediate grade bonds, (iii) provides liquidity for withdrawals by participants and beneficiaries (including investment transfers), (iv) does not impose fees or surrender charges in connection with withdrawals by participants and beneficiaries, and (v) invests primarily in investment products that are backed by state or federally-regulated financial institutions. Previously, the DOL required that principal and rates of return be guaranteed by a state or federally regulated financial institution, which precluded many stable value funds from qualifying for the “grandfather” relief. This correction is retroactive to the effective date of the final QDIA regulation;
- clarified the scope of the relief under the final QDIA regulation, including that relief under the final QDIA regulation will be available for previously invested amounts once the requirements, including the notice requirement, are satisfied. In this regard, the DOL noted that relief may be available after the 30-day notice requirement is satisfied, even where the notice was not provided before the effective date of the final QDIA regulation;
- clarified that a QDIA (other than a 120-day capital preservation QDIA or a grandfathered stable value fund QDIA) must contain some fixed income and some equity investments, and that a fund that contains no fixed income (*i.e.*, 100% equity) or no equity (*i.e.*, 100% fixed income) could not constitute a QDIA. The DOL indicated, however, that it does not intend to provide any guidance on how much fixed income or equity investments a QDIA must have;
- clarified that a “plan sponsor” that may manage a QDIA may include a committee of individuals consisting primarily of employees of the plan sponsor; and
- clarified that the limitation on restrictions, fees or expenses with respect to amounts withdrawn from the QDIA during the initial 90-day period does not apply to previously existing amounts invested in a QDIA, and also that round-trip restrictions are generally not prohibited.

The DOL also provided further guidance on other aspects of the final QDIA regulation, including with respect to the 120-day capital preservation QDIA.

➤ OTS Approves Foreign Operating Subsidiary in India

The OTS approved an application by a federal savings bank (the “FSB”) to acquire control of a company in India to be organized by the FSB for the purpose of monitoring the FSB’s relationship with foreign outsourcing providers. The OTS imposed several conditions on its approval, including requirements: (i) to make available to the OTS information concerning the activities of the foreign company; (ii) to consent to OTS jurisdiction over the foreign subsidiary; (iii) to agree to the disclosure by foreign regulatory authorities of supervisory information to the OTS; and (iv) to establish controls over the foreign company’s operations.

The OTS has previously required that the operations of a foreign operating subsidiary of an FSB be consistent with the “domestic focus” of the thrift charter and has approved the formation of foreign subsidiaries for the purpose of holding otherwise permissible assets. However, the agency has recently been somewhat more permissive in this area and, last year, permitted another FSB to establish an operating subsidiary in China to engage in foreign currency corporate lending, small business lending

and trade finance, and eventually other banking services. In that case, the OTS concluded that the operations in China would be “incidental to . . . domestic operations” because they represented less than 5% (or, as the OTS described it, a “small fraction”) of the parent FSB’s assets and revenues. The OTS has also permitted FSBs to establish foreign agency offices; however, it has not permitted FSBs to establish foreign branch offices.

➤ **OCC Issues Final Rule Reducing Regulatory Burden**

The OCC issued a final rule (the “Rule”) that amends certain OCC regulations to reduce or eliminate unnecessary regulatory burden, incorporate certain prior OCC interpretive opinions, conform OCC regulations to statutory changes made by the Financial Services Regulatory Relief Act of 2006 (see the July 17, 2007, October 17, 2006 and October 2, 2006 *Alerts*) and to make certain other technical and conforming changes.

Among the most important amendments made by the Rule are:

- (1) provisions with respect to national bank operating subsidiaries that:
 - (a) allow operating subsidiaries to be formed as limited partnerships;
 - (b) update the standards used by the OCC in determining whether an entity qualifies as an operating subsidiary;
 - (c) clarify when a national bank may file an after-the-fact notice to establish or acquire an operating subsidiary and when an application must be filed; and
 - (d) expand the list of operating subsidiary activities eligible for the filing of an after-the-fact notice.
- (2) provisions to codify OCC precedent and reflect certain current developments in electronic banking;
- (3) provisions that simplify a national bank’s authority to pay a dividend and that remove the geographic limits with respect to its bank service companies;
- (4) provisions that permit a national bank to choose whether to provide for cumulative voting in the election of directors;
- (5) provisions that revise the regulations under the Change in Bank Control Act (“CBCA”) that
 - (a) require a CBCA Notice to address the future prospects of the national bank to be acquired
 - (b) allow the OCC to issue a notice of disapproval using the future prospects of the national bank acquired as a basis for such disapproval; and
 - (c) permit the OCC to impose conditions in a letter of nonobjection to a CBCA Notice; and
- (6) provisions reducing the burden on national banks associated with applications for fiduciary powers (*e.g.*, elimination of the legal opinion requirement), applications for intermittent branches and requirements to make securities filings with the OCC.

The Rule takes effect on July 1, 2008.

➤ **OCC Issues Interpretive Letter Concerning Loans Made to Bank “Insiders”**

The OCC issued interpretive letter #1096 (“Letter #1096”) in response to a letter by a national bank that had granted two home equity lines of credit with a combined total exceeding \$100,000 to an individual, six months to one year prior to the individual becoming an executive officer of the bank. Letter #1096

recites the long standing position of both the FRB and the OCC that the requirements of Regulation O (12 C.F.R. Part 215) apply at the time a loan or extension of credit is made. Letter #1096 further provides that the loans or extensions made to an individual *prior* to the individual becoming an executive officer are “grandfathered” and do not constitute violations of Regulation O so long as the loan or extension of credit was not made in contemplation of the individual becoming an executive officer. Letter #1096 concludes that, if such “grandfathered” loans exceed the amount permitted by Regulation O, such loans will be considered nonconforming rather than a violation of Regulation O; however, so long as such loans are nonconforming, no new loans may be made, and existing loans may not be renewed.

➤ **OCC Issues Interpretive Letter Concerning Bank’s Ability to Hold Commercial Real Estate for a “Moment-In-Time”**

In interpretive letter #1907 (“Letter #1097”) the OCC permitted a national bank (the “Bank”) to purchase a small amount of “debts previously contracted” (“DPC”) real estate from a third party in connection with the Bank’s larger purchase of commercial real estate mortgage loans from a dissolving real estate trust by concluding that such purchase did not violate 12 U.S.C § 29, which restricts a national bank’s real estate activities. The OCC allowed the purchase of the DPC real estate because the Bank agreed to sell the DPC real estate immediately, to an unrelated third party, for the same purchase price the Bank paid to the trust. The OCC reasoned that, in the past it had permitted national banks to hold for a “moment-in-time” assets that national banks are generally not permitted to hold, if this was necessary for the national bank to carry out a transaction or activity that is permissible. In Letter #1097, the Bank represented that a “moment-in-time” acquisition of the DPC real estate was necessary to facilitate the purchase of loans secured by liens or real estate, a transaction expressly authorized under 12 C.F.R. § 34.3. Therefore, the OCC concluded that, the Bank’s “moment-in-time” acquisition of the DPC real estate would not be prohibited by 12 U.S.C. § 29.

➤ **New York, New Jersey and Pennsylvania Sign Interstate Regulation Pact**

Banking officials from New York, New Jersey and Pennsylvania signed a Regional Interstate Branching Memorandum of Understanding (“MOU”) that greatly expands the ability of state-chartered banks with interstate branches in the three states to be regulated by their home state regulator. Previously, under state and federal law, interstate branches of banks have been subject to overlapping regulation, examination and enforcement by the home state in which the bank is chartered and the host state in which the bank has interstate branches. The MOU took effect immediately upon signing. The MOU is intended to strengthen the state-chartered banking system in the greater New York metropolitan region. A significant number of state-chartered banks have converted to federal charters in recent years. Under a provision of federal law governing interstate branching of state chartered banks, the laws of a host state where a branch is located arguably do not apply to the branch if such laws would be preempted by federal law if applied to a branch of a national bank in that state. However, many states require out-of-state banks establishing branches in the state to comply with host state law and some states, as a matter of comity, require their banks to comply with host state laws when they establish an out-of-state branch. Accordingly, this provision of federal law has had limited effect.

Overlapping regulation by the home and host states with respect to interstate branches of state-chartered banks has resulted in additional regulatory burden for state-chartered banks relative to national banks and federal savings associations. The regulatory burden has been more pronounced in the areas of consumer and fee regulation. National banks and federal savings associations in many instances have been able to avoid differing state consumer and fee regulations under federal law preemption. The MOU is intended to result in less regulatory burden for interstate branches of state-chartered banks by applying the regulatory scheme of the home state to the bank’s interstate branches.

Under Article III of the MOU, activities of an interstate branch will be governed by the home state law “to the same extent that federal law governs the activities of a branch in the host State of an out-of-state

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national bank.” Differences of opinion among the states regarding whether a host state law would be preempted under this standard are to be resolved by the reasonable best efforts of the state regulators. Each state’s attorney general retains jurisdiction to enforce violations of non-preempted regulation. Examination and other visitation of state-chartered banks and their interstate branches generally will be conducted by the home state regulator, except in certain instances, *e.g.*, involving consumer complaints.

Other Items of Note

➤ California Announces that it Will Not Proceed with Proposed Narrowing of Private Adviser Licensing Exemption

The California Corporations Commissioner announced that it has decided not to proceed with a September 2007 proposal to amend the rules governing exemptions from the state’s investment adviser licensing requirements. The proposal would have eliminated the exemption currently available to an investment adviser that (a) relies on Section 203(b)(3) under the Investment Advisers Act of 1940, as amended (the federal adviser exemption for advisers with fewer than 15 clients), and (b) has at least \$25 million in assets under.

➤ OCC Issues Payment Processors Risk Management Guidance

The OCC issued a bulletin containing guidance for national banks regarding the higher risk presented by relationships with companies that process payments for telemarketers and certain other merchants. The guidance centers on due diligence, underwriting, and monitoring of such payment processors.