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DEVELOPMENTS OF NOTE

U.S. Court of Appeals for the First Circuit Affirms Judgment for Investment Manager on ERISA Breach of Fiduciary Duty Claims Involving Management of Retirement Plan Investments

The United States Court of Appeals for the First Circuit (the "First Circuit") affirmed the decision of the lower court granting summary judgment for an investment manager who acted as the fiduciary of an employer stock fund option within a defined contribution plan, and numerous other defendants, most of whom were employees or committees of the company sponsoring the plan, W.R. Grace & Co. (the "Company"). The plaintiffs in two actions that were subsequently consolidated alleged a breach of ERISA fiduciary duties arising from the holding, and then selling, of the plan's investments in the Company's stock. The very unusual twist in these cases was that one set of plaintiffs sued alleging that the fiduciaries should have sold the stock before the Company filed for bankruptcy protection, thus avoiding losses in the securities' price as the Company approached and then entered bankruptcy, while the other set of plaintiffs alleged that the investment fiduciary should have held the securities after the Company petitioned for Chapter 11 bankruptcy, as the stock subsequently rose in value. After the cases were consolidated by the district court, the proceeding simultaneously alleged a stock drop and a stock rise.

After a summary judgment record was converted to a proceeding as a case stated, the district court entered summary judgment. In affirming the decision of the district court, the First Circuit held that the investment manager selected by the plan's named fiduciary to exercise authority over disposition of the plan's holding of employer securities did not breach any fiduciary duties in its decisions with respect to first holding, and then selling, the securities. Specifically, the First Circuit found that the investment manager "unquestionably" met ERISA's prudent man standard by engaging in a process designed to assess the feasibility of continued holding or disposition of the security. The First Circuit specifically identified as evidence of its prudence the fact that the named fiduciary hired independent experts to advise it as to the proper discharge of its obligations. The court followed the settled view that under ERISA, a fiduciary's actions are not judged in hindsight, stating: '[a]lthough hindsight is 20/20 . . . that is not the lens by which we view a fiduciary's actions under ERISA." *Bunch et al v. W.R. Grace & Co. et al,* No. 08-1406 (1st Cir. Jan. 29, 2009).

Goodwin Procter was one of two independent experts specifically cited by the First Circuit as having been hired by the investment manager to advise it in determining what course to take with respect to the Company's stock held in the Company's defined contribution plan.

Congressional Oversight Panel Issues Special Report on Regulatory Reform

The Congressional Oversight Panel ("COP"), which was created pursuant to the Emergency Economic Stabilization Act of 2008 to oversee the Treasury's Troubled Asset Relief Program and review the current state of financial markets and the regulatory system, released a Special Report on Regulatory Reform (the "COP Report") in which it analyzed the current financial crisis and made recommendations for the future. The COP Report identified eight specific areas most urgently in need of reform:

(1) Identify and regulate financial institutions that pose systemic risk, including nonbank financial institutions, by creating a systemic regulator (either an existing agency or a new agency), imposing heightened regulatory requirements for systemically significant institutions, and establishing receivership and liquidation processes for systemically significant nonbank institutions which are similar to the system for banks.

(2) Limit excessive leverage in American financial institutions through enhanced capital requirements.

(3) Increase supervision of the "shadow financial system" of unregulated financial instruments such as over-the-counter derivatives, off-balance sheet entities such as conduits and nonbank financial institutions such as hedge funds and private equity funds.

(4) Create a new system for federal and state regulation of mortgages and other consumer credit products through the elimination of federal pre-emption of state consumer protection laws for national banks and the creation of a single federal regulator for consumer credit products.

(5) Create executive pay structures that discourage excessive risk taking through tax incentives which encourage long-term oriented pay packages, regulation of risk-rewarding compensation structures, "clawbacks" of bonus compensation and increased board oversight.

(6) Reform the credit rating system by addressing conflicts of interest and creating a Credit Rating Review Board.

(7) Make establishing a global financial regulatory floor a U.S. diplomatic priority.

(8) Plan for the next crisis through the creation of a Financial Risk Crisis Council of outside financial experts.

The COP Report also identified three areas that the relevant regulatory agencies should review: accounting rules, securitization, and short-selling. The COP Report will be a key factor as Congress and the new administration weigh broad changes to the U.S. financial system. The COP stated that it plans to address regulatory architecture more thoroughly in a subsequent report, including the issues of co-regulation, universal banking, regulatory capture, the revolving door problem, bankruptcy and receivership issues involving financial institutions, and the division of regulatory responsibilities.

Update on FRB Liquidity Programs

FRB Extends Liquidity Programs

The FRB extended through October 30, 2009, its existing liquidity programs that were scheduled to expire on April 30, 2009. The FRB approved the extension through October 30, 2009 of the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (the "ABCP Facility"), the Commercial Paper Funding Facility, the Money Market Investor Funding Facility, the Primary Dealer Credit Facility, and the Term Securities Lending Facility (the "TSLF"). The Federal Open Market Committee ("FOMC") also took action to extend the TSLF, which is established under the joint authority of the FRB and the FOMC.

FRB Adopts Final Rules to Extend Exemptions Relating to the ABCP Facility

The FRB adopted two final rules pertaining to its the ABCP Facility, a program that was intended to assist money market funds in obtaining liquidity to meet redemptions. The two final rules are similar to the interim regulatory exemptions adopted by the FRB in September 2008 at the time the FRB created the ABCP Facility. *See* the September 23, 2008 *Alert*. The interim rules provided exemptions from (a) the FRB's risk-based capital rules for bank holding companies and state member banks in Regulation W, and (b) restrictions on and requirements for transactions between banks and bank affiliates in Sections 23A and 23B of the Federal Reserve Act. As noted above, since the FRB adopted the interim rules, the availability of the ABCP Facility has been extended from its original expiration date of January 31, 2009 to October 30, 2009. The final rules principally extend the exemptions provided in the interim rules through the ABCP Facility's new expiration date.

FRB Adopts Final Rules to Extend Exemption Relating to Certain Financing Transactions between Member Banks and Affiliates

The FRB adopted a final rule to extend an interim rule adopted in September 2008 that provided a temporary exemption from the limits in Section 23A of the Federal Reserve Act and the FRB's Regulation W to permit an affiliate of a member bank (such as a broker-dealer) to obtain financing, if needed, from the member bank for securities or other assets that the affiliate ordinarily would have financed through the tri-party repurchase agreement market. The temporary exception provided is subject to various safety and soundness conditions. The final rule is identical to the interim rule, except that it extends the

expiration date of the exemption from January 30, 2009 to October 30, 2009. The interim rule was discussed in the September 16, 2008 *Alert.*

FDIC's Proposed Revisions to Interest Rate Restrictions on Institutions that are Less than Well-Capitalized

The FDIC proposed a rule (the "Proposed Rule") that would make certain revisions to the interest rate restrictions in its regulations regarding brokered deposits to provide greater flexibility to institutions that are not well-capitalized. The Proposed Rule would address concerns caused by the fact that the U.S. Treasury bond-yield benchmark for brokered deposits of such institutions under the current rule is abnormally low, making it difficult for the institutions to attract brokered deposits due to compressed limits on permissible brokered deposit rates.

Under existing Part 337.6 of the FDIC's regulations, a bank or thrift that is less than well-capitalized may not pay an interest rate that significantly exceeds the prevailing rate in the institution's market area or the market area in which the deposit is accepted. For out-of-area brokered deposits the rate to be followed is the "national rate," which is defined as 120 percent of the current yield on similar maturity U.S. Treasury obligations.

The Proposed Rule would redefine the "national rate" for purposes of the rule to be "a simple average of rates paid by all depository and branches for which data are available." In other words, the prevailing rate in all market areas for deposits of similar size and maturity would be the "national rate." As an alternative, the FDIC also would permit an institution that believes the prevailing rates in its area exceed the national average to redefine its market area, provided, however, that the institution must overcome a rebuttable presumption that the national rate should be used by providing support to the FDIC of the existence of such higher local rates.

To provide institutions with the rate information needed to comply with the Proposed Rule, the FDIC would publish a schedule of "national rates" by maturity. The rate caps for such deposits, which would be the national rate plus 75 basis points, also would be provided. Comments on the Proposed Rule are due by April 6, 2009.

FDIC Adopts Final Rule on Processing of Deposit Accounts in the Event of Failure

The FDIC issued a final rule (the "Final Rule") establishing the FDIC's practices for determining deposit and other liability account balances in the event of a failure of an insured depository institution (a "DI"). The Final Rule is substantially the same as the interim rule issued in July 2008 regarding this topic, and, to a large extent, is a codification of long-standing FDIC practices and procedures.

The Final Rule describes the method under which the receiver of a failed insured DI will construct an ending balance sheet for the DI and determine the value and nature of the claims against such failed DI, including claims to be made by depositors, general creditors, subordinated creditors and shareholders. Pursuant to the Final Rule, the FDIC, as insurer and receiver, will generally treat deposits and other liabilities of the failed DI according to the ownership and nature of the underlying obligations based on end-of-day ledger balances for each account using the DI's normal posting procedures. However, the Final Rule allows the FDIC to establish an FDIC Cutoff Point, coinciding with the point in time at which the receiver acts to stop deposit transactions which might result in creating new liabilities or

extinguishing existing liabilities resulting from external transactions. As of the FDIC Cutoff Point, the FDIC will use its best efforts to take all steps necessary to stop the generation, via transactions or transfers coming from or going outside the DI, of new liabilities or extinguishing existing liabilities for the DI. The Final Rule does not require a DI to adjust its systems, policies or procedures to accommodate the receiver's responsibility in this regard.

With respect to sweep accounts, in making claims determinations on funds swept from a deposit account yet still residing *within* the DI, the FDIC will use the following guidelines: (1) ownership of the funds and the nature of the claim will be based on records established and maintained by the DI for that specific account or investment vehicle; (2) depositor owned funds residing in a general ledger account as of the DI's end-of-day will be treated as a deposit for insurance purposes (further, in calculating deposit insurance, these funds will be aggregated with the balance in the deposit account from which they originally were swept if their ownership interest has not changed, and will be aggregated with the transaction deposit account balances of the new owner if there has been a change in ownership); and (3) the full amount of swept funds attributable to an individual customer residing in an omnibus or other commingled account as of the DI's normal end-of-day will be treated as belonging to that customer, regardless of any netting practices established by the DI. In the case of funds swept *outside* of the DI, in the event of failure the swept funds also will be treated consistent with their status in the end-of-day ledger balances of the depository institution and the external entity. If an expected transfer to the external sweep investment vehicle is not completed prior to the FDIC Cutoff Point, the external investment will not be purchased and the funds will remain in the account identified on the end-of-day ledger balance. (For more information, see the Final Rule itself, which provides a detailed discussion of how the FDIC will treat funds associated with various specific sweep products in the event of failure.)

Moreover, the Final Rule imposes certain disclosure requirements in connection with sweep accounts. As of July 1, 2009, DIs must prominently disclose in writing to sweep account customers whether their swept funds are deposits within the meaning of 12 U.S.C. 1813(l): (1) within 60 days after July 1, 2009, and no less than annually thereafter; (2) in all new sweep account contracts, and (3) in renewals of existing sweep account contracts. Furthermore, if the funds are not deposits, the institution must disclose the status such funds would have if the institution failed (*e.g.*, general creditor status or secured creditor status). These disclosure requirements do not apply to sweep accounts where: (a) the transfers are within a single account, or a sub-account; or (b) the sweep account involves only deposit-to-deposit sweeps, such as zero-balance accounts, unless the sweep results in a change in the customer's insurance coverage. For external sweep arrangements, the required disclosures also should indicate the possibility that, if the DI should fail, the applicable funds might not be swept to the source outside the institution and should indicate how the funds would be treated in that situation. The Final Rule does not impose specific disclosure language, but rather allows DIs to form their own disclosures, as long as they satisfy the provided disclosure requirements. The Final Rule becomes effective on March 4, 2009. As noted above, the disclosure requirements with respect to sweep accounts go into effect on July 1, 2009.

OCC Concludes Banks' Senior Unsecured Debt Covered by FDIC Guarantee is Exempt from OCC Registration Requirement

The OCC issued an interpretive letter ("Letter #1108) in which the OCC confirmed that a national bank's senior unsecured debt that is guaranteed (for the full period it is outstanding) by the FDIC under the FDIC's Temporary Liquidity Guarantee Program ("TLGP") is exempt from the OCC's registration requirements under 12 C.F.R. §16.5 ("Section 16.5").

As one of two current programs under the TGLP, the FDIC established a debt guarantee program (the "Debt Guarantee Program"), which temporarily guarantees newly issued senior unsecured debt of participating FDIC-insured depository institutions and U.S. holding companies ("Banks") up to prescribed volume limits. The Debt Guarantee Program applies to eligible debt issued by Banks that matures on or before June 30, 2012.

Letter #1108 states that the SEC has confirmed to the FDIC that eligible debt under the Debt Guarantee Program that matures on or before June 30, 2012 (*i.e.*, that is guaranteed for the full period it is outstanding) is exempt from registration under the Securities Act of 1933 because the debt is "guaranteed by an instrumentality of the United States." Since such debt is exempt from SEC registration for reasons other than for the fact that it is issued by a bank, the OCC concludes in Letter #1108 that eligible debt under the TLGP is exempt from registration with the OCC under Section 16.5.

The OCC stated that the exemption will apply as long as a bank continues to participate in the TLGP, but, as noted above, the exemption remains subject to the June 30, 2012 maturity requirement.

OTHER ITEMS OF NOTE

Goodwin Procter Hosts Webinar on New Massachusetts Data Privacy Regulations Applicable to Businesses Nationwide Holding Personal Information of Massachusetts Customers

On January 15, 2009, Goodwin Procter's Privacy and Data Security Task force presented a webinar entitled, "New Data Security Regulations Reach Beyond State Lines." The session focused primarily upon Massachusetts' comprehensive new data security regulations that are scheduled to go into effect on May 1, 2009. The speakers examined the scope and requirements of the new rules, analyzed the inter-relationship between the Massachusetts rules and other information security requirements, explored best practices for information security policy development and implementation, and shared views on current trends in this area, including other states that may be considering similar legislation.

The program materials and a recording of the webinar are posted on the News & Events section of the Goodwin Procter website at Webcast Materials.

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Goodwin Procter Issues Client Alert on Bill That Would Require Certain Private Funds and Their Advisers to Register with the SEC

Goodwin Procter has prepared a Client Alert discussing the provisions of a bill introduced in the U.S. Senate that is designed to require unregistered funds that rely on Sections 3(c)(1) or 3(c)(7) under the Investment Company Act of 1940, as amended, and those funds' advisers, to register with the SEC. The Client Alert is available on the Goodwin Procter website at Client Alert.