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Financial Services Alert

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➢ FRB Grants Risk-Based Exception for Margin Loans

The FRB granted an exception permitting a bank holding company ("BHC") to reduce the risk-based capital impact of the Regulation T margin loans of its broker dealer subsidiary. Under the current standard capital rules, such loans generally would require a 100 percent risk weight. However, the BHC cited its low loss rates on such loans, their high level of collateralization, and the competitive disadvantage that it has faced given that broker dealers that are not part of BHCs, as well as foreign banks, do not face similar capital charges. Based on these factors, as well as the fact that recent changes in federal bankruptcy law provide a strong basis to assert that margin loan transactions are not subject to stay proceedings in the event of the borrower's bankruptcy, the FRB permitted the BHC to apply a 10 percent risk-weight to these transactions, provided that: (1) the securities collateral is liquid and readily marketable; (2) the margin loans and collateral are marked-to-market daily; (3) the margin loans are subject to initial and daily margin-maintenance requirements; and (4) the BHC has a reasonable basis to conclude that it could liquidate the collateral without undue delay in the event of borrower bankruptcy. The FRB also noted that granting this relief is consistent with the purposes of the Gramm-Leach-Bliley Act, the legislative history of which suggests Congress intended the FRB, to the extent consistent with safety and soundness, to make the risk-based capital requirements for BHCs that own broker-dealers consistent with the capital standards applied by the SEC to broker-dealers.

➢ Federal District Court Dismisses Excessive Fee Suit against Mutual Fund Adviser and Distributor

The US District Court of Minnesota (the "Court") ruled in favor of a mutual fund adviser (the "Adviser") and its affiliated mutual fund distributor (the "Distributor") on a motion to dismiss a suit brought by shareholders of registered open-end funds managed by the Adviser (the "Funds") under Section 36(b) of the Investment Company Act of 1940, as amended (the "1940 Act"). The derivative suit alleged that the Adviser and Distributor had breached their fiduciary duty to the Funds under

Section 36(b) by charging excessive advisory fees and excessive distribution fees (the distribution fees being fees paid by the Funds under plans pursuant to Rule 12b-1 under the 1940 Act ("12b-1 fees")) and by using distribution fees as a means of securing additional compensation for advisory services.

According to the Court, the plaintiffs primarily argued that the Adviser's fees were excessive relative to the Funds' performance and relative to the lower fees paid by the non-mutual fund institutional accounts. The plaintiffs also contended that numerous elements of the process culminating in the Funds' approval of the fees in question were flawed. The Court's decision was on a summary judgment motion for dismissal by the Adviser and Distributor.

The Contract Review Process. In reviewing the facts of the case, the Court noted that before approving the advisory fees, the Funds' board of directors (the "Board") met numerous times to review both the investment performance of the Funds and the profitability of the contracts to the Adviser. The Court also noted that the Board sought the advice of independent counsel and third party consultants, used a contracts committee of the Board to review the arrangements in question and make recommendations to the full Board, sought and received information from the defendants related to the contract renewal process pursuant to Section 15(c) of the 1940 Act, commissioned Lipper, Inc. to produce comparative fee information for the Funds relative to their competitors and received a report that provided information concerning the similarities and differences between the fees charged and services provided to non-mutual fund clients, including institutional investors, by the defendants. The Court noted that the Board had approved fee schedules for each Fund with breakpoint reductions in fee levels as asset levels increase. The Court's opinion discussed the Board's pricing philosophy, which, in general terms, sought to set a Fund's fees at the median for comparable funds in the industry with the Board willing to pay fees above the median if performance was good, but seeking fees below the median if performance was poor. The pricing philosophy also included considerations related to the defendants' Fund distribution role and economies of scale and profitability. The Court observed that during the relevant period the Funds' investment returns had been generally above the median for their Lipper peer groups, while their advisory fees, which included a performance adjustment keyed to a Fund's performance relative to its Lipper peer group, was at or below the median for their peer groups.

The Court's Analysis. The Court identified *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982) ("*Gartenberg*") as the seminal case on Section 36(b). The Court indicated that, under *Gartenberg*, it must investigate whether there was a genuine issue of material fact as to whether the fees charged by the Adviser and Distributor were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining. To do so, the Court applied the six factor *Gartenberg* test to the facts of the case, those factors being: (1) the nature and quality of the services provided by the adviser to the shareholders; (2) the profitability of the mutual fund to the adviser; (3) the benefits, other than the advisory fees, that flow to the adviser or its affiliates as a result of the adviser's relationship to the fund; (4) the economies of scale realized by the adviser as the fund's assets increase; (5) the comparative fee structures of similar funds; and (6) the independence and conscientiousness of the independent directors. After weighing each of these factors, the Court found that the plaintiffs had not established a material issue of fact on any of the *Gartenberg* factors, and thus their suit could not survive summary judgment.

Addressing what it identified as one of the plaintiffs' primary arguments, the Court noted that, since *Gartenberg*, courts have held that other mutual funds provide the relevant comparison for measuring the reasonableness of fees, not non-mutual fund institutional clients. Further, the Court noted that even if comparing mutual fund fees to non-mutual fund fees were relevant, the plaintiffs did not demonstrate that the services provided to the different types of funds were comparable, or that the discrepancy in rates did not merely indicate the range of prices that investors were willing to pay, citing a Section 36(b) case decided in the North District of Illinois earlier in 2007 (as discussed in the March 20, 2007 *Alert*). In dismissing the plaintiffs' allegations regarding the Funds' 12b-1 fees, the Court observed, among other things, that approximately eighty-five percent of the 12b-1 fees were paid for services to existing shareholders and not for marketing the Funds to new shareholders, thus rendering meritless the plaintiffs' claims that shareholders received no benefit from the Funds' Rule 12b-1 fees.

➢ SEC Chairman Issues Letter Concluding that a Mortgagor's Modification of Securitized Loans when Default is "Reasonably Foreseeable," but Before Default Occurs, Does Not Violate FAS 140

In response to a written inquiry to the SEC from the U.S. House of Representatives' Committee on Financial Services (the "Committee") sent in connection with the Committee's deliberations concerning how best to address rising U.S. residential mortgage foreclosure rates, Chairman Cox of the SEC issued a responsive letter to the Committee (attaching a memorandum from the Chief Accountant of the SEC) addressing the issue of whether a mortgagor's modification of the terms of a securitized loan when default is reasonably foreseeable (but before the occurrence of delinquency or default) violates the requirements of Financial Accounting Standards Board Statement No. 140 ("FAS 140"), the accounting standard that provides guidance on securitization transactions. Specifically, the Committee sought guidance as to whether a mortgagor's modification of the terms of a loan when default is "reasonably foreseeable" would preclude off-balance sheet treatment of the loan under FAS 140. Typical modifications include: (1) reducing the interest rate of the loan; (2) extending the maturity of the loan; or (3) granting other similar types of concessions to a borrower. Off-balance sheet treatment is critical to financial institutions engaged in securitization transactions because such treatment allows such financial institutions to reduce their regulatory capital requirements. The SEC concludes that it is both the view of the SEC and the consensus of accounting practitioners that "entering into loan restructuring or modification activities (consistent with the nature of activities permitted when a default has occurred) when a default is reasonably foreseeable does not preclude continued off-balance sheet treatment under FAS 140."

➢ SEC Adopts Proxy Rule Changes Mandating Internet Availability of Proxy Materials

The SEC voted to adopt amendments to the proxy rules under the Securities Exchange Act of 1934, as amended (the "1934 Act"), that will require issuers and other persons soliciting proxies to use the notice and access model of providing proxy materials, which involves posting proxy materials on an Internet website (other than the SEC EDGAR website) and providing shareholders with a notice of the Internet availability of the materials. (Use of the notice and access model does not apply to a business combination transaction, or where prohibited by the law of the issuer's state of incorporation). Under the rule amendments, an issuer may initially meet its obligations under the proxy rules by furnishing only a notice of Internet availability of proxy materials, doing so at least 40 days before the shareholder meeting, but must subsequently provide copies of the proxy materials in response to any shareholder requests for them. Alternatively, an issuer may furnish paper copies of the proxy materials along with the notice. A single solicitation may include the use of both solicitation methods, *i.e.*, an issuer may use the "notice only" option to provide proxy materials to some shareholders and the "full set delivery" option to provide proxy materials to other shareholders. Soliciting persons other than issuers must generally meet the same requirements as issuers under the rule amendments subject to certain exceptions, *e.g.*, non-issuer soliciting persons need not solicit every shareholder. Intermediaries must use the notice and access model in furnishing an issuer's proxy materials to beneficial owners.

The rule amendments are generally effective January 1, 2008. "Large accelerated filers," as that term is defined in Rule 12b-2 under the 1934 Act, not including registered investment companies, must comply with the rule amendments commencing beginning on or after January 1, 2008. Registered investment companies, persons other than issuers, and issuers that are not large accelerated filers may comply with the rule amendments on or after January 1, 2008, but must comply with them for proxy solicitations commencing on or after January 1, 2009. A future *Alert* will discuss the proxy rule amendments in greater detail.

➢ SEC Staff Issues Denial of No-Action Request Regarding Broker-Dealer Registration to Company Acting as a Financial Consultant and Finder of Investors for Small Businesses

The staff of the SEC's Division of Market Regulation (the "Staff") issued a letter to Hallmark Capital Corporation ("Hallcap") denying Hallcap's request for no-action relief regarding the requirement to register with the SEC as a broker-dealer pursuant to Section 15(b) of the Securities Exchange Act of 1934 (“Exchange Act”). Hallcap stated in its request letter that the financial services it currently provides to companies fall within three general categories: (1) assisting small businesses in raising equity and debt capital; (2) assisting small businesses with mergers and acquisitions; and (3) providing issuers with strategic business consulting services.

Hallcap stated in its letter that its equity capital-raising services include identifying and arranging meetings with broker-dealers that may be interested in raising equity capital for issuers, while its debt capital-raising services include assisting issuers with loan applications and identifying and arranging meetings with bank lenders that may be interested in extending bank credit facilities to issuers. Hallcap stated that the merger and acquisition services it offers include identifying entities that might be interested in buying client issuers, qualifying such entities’ ability to pay the client issuer’s asking price and arranging exploratory meetings between the client issuers and potential buyers. Hallcap also assists client issuers wishing to acquire other companies by identifying possible acquisition targets, conducting preliminary information gathering interviews (including a discussion of potential target companies expected asking prices and terms), and preparing acquisition profiles of target companies. Finally, Hallcap represented that it provides clients with strategic planning advice with respect to business and management issues and assistance with formulating and implementing corporate marketing and general public relations strategies.

As compensation for providing the equity and debt capital-raising services and the mergers and acquisition services, Hallcap stated that, in addition to a “modest upfront retainer,” it receives a fee based on the outcome of the transactions. In connection with the strategic business consulting services, Hallcap states that it receives only a pre-negotiated fixed fee. In support of its request for no-action relief, Hallcap contended that it should not be required to register as a broker-dealer based on the limited scope of its activities, including that it: (i) does not handle the securities or funds of others; (ii) does not effectuate transactions for the account of others, (iii) does not take a central role in negotiations leading to a completed transaction, (iv) does not bind parties to the merger and acquisition transactions for which it provides consulting services; (v) does not act as an agent on behalf of its client companies, and (vi) does not solicit investment funds from the general public.

Without providing any analysis or specific reasons for denying Hallcap’s request, the Staff summarily stated in its letter denying no-action relief that it “appears” that Hallcap would be required to register with the SEC as a broker-dealer pursuant to the Exchange Act “based on the general descriptions of the activities” set forth in Hallcap’s request letter. While the Staff did not provide its reasons for denying Hallcap’s request, it is important to note the Staff has in the past held that, while not the only factor, the receipt of transaction-related compensation in connection with the facilitation, solicitation, effecting or execution of securities transactions is a hallmark of “broker” activity that weighs heavily in favor of requiring registration under the Exchange Act. In this regard, the fee Hallcap receives that is contingent upon the successful completion of a capital-raising transaction, merger or acquisition for a client issuer would constitute transaction-related compensation. Other factors weighing in the direction of Hallcap’s status as a “broker” under the Exchange Act include its activities in connection with identifying and introducing potential equity investors and lenders to issuers. In this regard, the Staff apparently did not agree with Hallcap’s categorization of itself as a “finder” that “plays a very limited role in the execution of a transaction once the preliminary exploratory process has been completed and the parties have expressed serious interest in pursuing a possible transaction.”

Other Items of Note

➢ SEC Staff Publishes Information Designed to Assist Newly-Registered Investment Advisers in Understanding Advisers Act Compliance Obligations

The staff of the SEC’s Division of Investment Management and Office of Compliance Inspections and Examinations published an information sheet designed to assist newly-registered advisers in understanding their compliance obligations under selected provisions of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and related rules. The Advisers Act requirements summarized in the information sheet include those relating to compliance programs, Form ADV, codes of ethics and insider trading procedures, recordkeeping, best execution obligations for client transactions, advertising and custody of client assets. The information sheet provides online reference resources regarding each of the topics it discusses, including SEC releases and no-action letters, and applicable statutory provisions and rules.

➢ SEC Votes to Issue Concept Release Soliciting Public Comment on Use of International Financial Reporting Standards by U.S. Issuers

The SEC voted unanimously to publish a concept release seeking public comment on whether U.S. issuers, including investment companies, should be allowed to prepare their financial statements using International Financial Reporting Standards ("IFRS") as published in English by the International Accounting Standards Board. The SEC's current rules require U.S. issuers to prepare financial statements in accordance with accounting principles that are generally accepted in the United States, often referred to as "U.S. GAAP." According to the SEC, nearly 100 countries currently require or allow the use of IFRS. The comment period for the concept release, which has not yet been made publicly available, will run for 90 days following the concept release's publication in the *Federal Register*.