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U P D A T E

News of Developments in the Financial Sector and Related Areas

Regulation of Hedge Funds

Predatory Lending

Cases, Releases and Rulings

Regulation of Hedge Funds

The Securities and Exchange Commission has undertaken a review of hedge funds including (i) the structure, operation and compliance activities of hedge funds, (ii) marketing issues, (iii) investor protection issues, (iv) the current regulatory scheme, and (v) whether additional regulation is warranted. Because hedge funds involve a variety of risks, investors in hedge funds are traditionally high net worth individuals and institutional investors such as insurance companies, financial institutions and pension funds. A hedge fund is defined as a fund which is managed aggressively to get maximum rates of returns by using derivates and swaps, selling short, and using arbitrage techniques. David Smith of the business staff of the *Arkansas Democrat Gazette* and a talented writer recently quoted a manager of a hedge fund as saying, "It's definitely not for the widows and orphans." Many states require managers of hedge funds to register as investment advisers. The National Association of Securities Dealers, Inc. ("NASD") has advised in a *Notice to Members 03-07* that it is concerned about the sales practices of some of its members who sell direct interests in hedge funds and indirect interests through funds of hedge funds because of the popularity of the funds. As a result of a recent review of members that sell hedge funds, the NASD staff indicated that members may not be fulfilling their sales practice obligations when selling these instruments, especially to retail customers. A member firm that recommends hedge funds must have a belief that the product is suitable for any investor by examining the customer's financial status, the customer's tax status, the customer's investment objectives and such other information used or considered to be reasonable in making recommendations to a customer. In its *Notice to Members*, the NASD indicated that retail customers may not understand the risks associated with investing in hedge funds. Depending on the sophistication and type of an investor in a hedge fund, a filing may be required with the Arkansas Securities Department. Commercial Capital Bancorp, the holding company for a small California bank that targets wealthy people, has created a subsidiary to manage a newly formed hedge fund that will invest in mortgage-backed securities as an alternative to offering its customers mutual funds and annuities.

Predatory Lending

The Arkansas General Assembly recently enacted Act 1340 of 2003 which is known as the *Arkansas Home Loan Protection Act* which is designed to prohibit predatory lending in the home mortgage market. The new Arkansas law contains a number of prohibitions and provides for punitive damages when a violation is malicious or reckless. The Attorney General for the state of Arkansas is charged with enforcement of the new law. Since the enactment of the Arkansas law, the Office of the Comptroller of the Currency ("OCC") has issued an order stating that the Georgia Fair Lending Act which prohibits predatory lending does not apply to any national bank or national bank operating subsidiary that engages in real estate lending activities in Georgia. OCC Advisory Letter AL 2002-9 reflects the position of the OCC that it has exclusive authority over national banks and their operating subsidiaries. The Advisory Letter informs national banks to consult with the OCC in the event a state authority seeks the enforcement of state laws over a national bank. The Office of Thrift Supervision has taken similar action to that of the OCC in connection with predatory lending laws in New York and New Jersey. It is unknown at this time what position the OCC will take in regard to the predatory lending law recently enacted in Arkansas.

Cases, Releases and Rulings

The Federal Reserve Board ("FRB") has issued an interpretive ruling finding that aircraft title abstracting is incidental to the business of banking and permissible for a bank holding company subsidiary. The FRB had received a request from a bank holding company to establish a new subsidiary that would (i) prepare title abstracts on aircraft, (ii) provide escrow services with respect to funds and documentation in connection with the sale or financing of aircraft, and (iii) sell title insurance as an agent. The FRB had previously held in The *First National Company*, 81 Federal Reserve Bulletin 805, 806 (1995) that title abstracting activities with respect to real property is an activity that is "so closely related to banking or managing or controlling banks as to be a proper incident thereto" within the meaning of Section 4(c)(8) of the Bank Holding Company Act. The FRB concluded that the title abstracting activities in connection with aircraft were essentially identical to the title abstracting activities previously approved by the FRB for real estate.

Suncoast Schools Federal Credit Union located in Florida and Cuna Mutual Insurance Society, an organization composed of credit unions, has received approval from the Office of Thrift Supervision for a thrift charter called Members Trust Co. which will offer trust services nationwide to members and nonmembers of participating credit unions. Members Trust Company, which will begin operations later this year, will target less affluent individuals, both members and nonmembers of participating credit unions, who might not qualify for the typical trust operations of a bank.

The Office of the Comptroller of the Currency ("OCC") has recently issued interpretive letters regarding the activities of national banks. In Interpretive Letter No. 968, the OCC held that after a company, which is currently a holding company affiliate of a national bank, becomes an operating subsidiary of a national bank, it may impose and export interest charges permitted by North Carolina law on consumer loans that it makes both in North Carolina and throughout the United States. The operating subsidiary would include in its loan documents a governing clause disclosing to borrowers that interest, including loan fees considered to be interest under federal law, would be governed by federal and North Carolina law. In Interpretive Letter No. 965, the OCC held that a bank could, through an operating subsidiary, purchase stock in an insurance company, when doing so was necessary for the bank to obtain insurance for its permissible activities. The bank needed to obtain professional liability insurance for its insurance agency subsidiary and the insurance company would only provide coverage to its shareholders. The required share purchase by the operating subsidiary of the bank was small and the bank had no investment motive.

Mr. Binns is available to meet with your organization or group relating to shareholder issues, increasing capital, regulatory and compliance, areas of profitability, marketing and management responsibilities. He is a frequent speaker on matters regarding mergers, acquisitions, commercial law, securities and banking law. Prior to entering the private practice of law, Mr. Binns was an accountant practicing with an emphasis on securities regulation and regulatory compliance.

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