INVESTMENT MANAGEMENT UPDATE

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Kentucky v. Davis – Supreme Court Upholds Tax Exemption for Interest on In-State Municipal Bonds

In 2006, a Kentucky state court held that it violates the United States Constitution for Kentucky to tax out-of-state municipal bonds while exempting in-state municipal bonds. On appeal, the U.S. Supreme Court reversed the Kentucky state court decision. The effect of the Supreme Court's ruling is to leave intact the longstanding practice of exempting in-state municipal bond interest but taxing interest on out-of-state bonds. This decision alleviates widespread concern that a different outcome might have had disruptive effects on the municipal bond markets.

SEC Not Permitted to Seek Civil Penalty in Civil Proceedings for "Aiding and Abetting" Violations of the Investment Advisers Act

The United States District Court for the District of Columbia recently decided that the Securities and Exchange Commission (the "SEC") lacks the authority to seek monetary penalties in civil judicial proceedings for aiding and abetting other persons who commit violations of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The SEC commenced an action against Washington Investment Network ("WIN"), a registered investment adviser nominally owned by Robert Radano and Susan Bolla, the wife of Steven M. Bolla. Although Steven Bolla was not an owner of WIN, the court found that he was the principal figure in charge of directing WIN's activities. The SEC claimed that WIN violated Section 203(f) of the Advisers Act by continuing to associate with Steven Bolla after it knew he had been barred from serving as an investment adviser. Steven Bolla and Susan Bolla agreed to a settlement of the civil action brought by the SEC and a bench trial was held to determine the liability of WIN and Radano. The district court found WIN liable for violating Sections 203(f), 206(1) and 206(2) of the Advisers Act, due to its continued association with Bolla after he was barred from serving as an adviser. The court also found that Radano aided and abetted WIN's violations, and imposed a $15,000 civil penalty against him. Radano filed a post trial motion to set aside this penalty, arguing that he could not be found liable under the Advisers Act in a civil action on an aiding and abetting theory due to the lack of specific authorization within Section 209(e) of the Advisers Act to impose civil monetary penalties. The court agreed with Radano's argument that if Congress had intended to provide the SEC with authority to seek penalties and other remedies against aiders and abettors as well as primary violators, it could have included such authority in the statute. The court noted that such authority was expressly granted in various other securities laws. The SEC argued that a ruling in favor of Radano's position would be inconsistent with Section 203(i) of the Advisers Act, which allows the SEC to seek monetary penalties from aiders and abettors in administrative proceedings. The court was not troubled by this apparent inconsistency and granted Radano's motion to amend, vacate, and relieve him from that portion of the final judgment imposing a monetary penalty against him.

Sound Practices for Preventing and Detecting Unauthorized Proprietary Trading

In a recent Regulatory Notice, the Financial Industry Regulatory Authority ("FINRA") advised its members that, in recent months, a number of banks and broker-dealers have suffered significant losses as a result of unauthorized proprietary trading. To aid member firms in assessing the adequacy of their internal controls, FINRA surveyed the practices employed by several firms and released the Regulatory Notice to provide its members with guidance as to sound practices guarding against this type of "rogue" trading.

Among the sound practices recommended by FINRA are:

- Mandatory vacation policies. Implementing, and enforcing, minimum annual vacation requirements for employees in sensitive positions.

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- Heightened scrutiny of red flags. Firms should pay close attention to certain indicators of potential unauthorized trading, such as trading limit breaches, unrealized profit and loss on unsettled transactions, unusual patterns of cancellations and corrections, aged unresolved reconciling items, aged outstanding confirmations, and repeated or unusual requests by traders for control exemptions.
- Protection of systems and risk management information. Firms should ensure traders do not have access to back-office functions. Knowledge of surveillance and monitoring procedures should also be limited to those employees performing these functions.
- Supervision and accountability. Reporting responsibilities should be clearly delineated, particularly in environments where employees report to multiple managers.
- Intercompany transactions. Firms may want to consider whether internal controls applicable to third-party transactions are also appropriate for transactions between affiliates.
- Compliance culture. Trade reconciliation and risk management departments should be adequately funded, independent of revenue-generating operations, and empowered with sufficient authority and clout within the organization to effectively perform their role.

FASB 161 Requires Additional Disclosure about Derivative Investments and Hedging Activities

In response to recent increases in the use and complexity of derivative instruments and hedging activities, in March 2008, the Financial Accounting Standards Board ("FASB") amended FASB Statement No. 133 ("FASB 133") by issuing FASB Statement No. 161 ("FASB 161"), entitled *Disclosures about Derivative Instruments and Hedging Activities*. FASB 161 expands upon the disclosures already required by FASB 133 to help users of financial statements better understand how and why an entity uses derivative instruments, how derivatives and related hedged items are accounted for under FASB 133, and how an entity's financial position, financial performance and cash flows are affected by the use of these types of instruments. Specifically, for each reporting period, entities must disclose their objectives for holding or issuing derivative instruments, the context needed to understand those objectives, and their strategies for achieving those objectives. A distinction must be made between instruments used for risk management and those used for other purposes. Transparency is improved by requiring line item(s) of the fair value amounts of derivative instruments be identified in the statement of financial position, and by requiring the amount of gains and losses be reported in the statement of financial performance, quantitatively, in a tabular format. The information is to be presented by type of derivative contract, for instance, interest rate, foreign exchange, equity, commodity, credit or other types of contracts. In addition, entities must disclose credit-risk-related contingent features of any derivative instruments they hold or issue. They must also disclose the circumstances in which the features could be triggered in derivative instruments that are in a net liability position at the end of the reporting period and their aggregate fair value amounts.

FASB 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008.

Appeals Court Rejects Mutual Fund Excessive Fee Claims, Adopting New Standard for Evaluation of Fees

In a significant setback for plaintiffs' lawyers taking aim at advisory and distribution fees, on May 19, 2008, the U.S. Court of Appeals for the Seventh Circuit affirmed the grant of summary judgment to a mutual fund adviser on a claim thatits fees were excessive in violation of Section 36(b) of the Investment Company Act. In Jones v. Harris Associates, the Seventh Circuit expressly rejected the widely applied Gartenberg standard for assessing advisers' liability for excessive fees because that opinion relied "too little on markets" and paid inadequate attention to the approval by independent trustees that the Act contemplates. The court thus erected a new standard, at least in the Seventh Circuit. To learn more about this decision, please read Ropes & Gray's **Litigation Alert**.

401(k) Plan Administrator May be Liable for IRA Rollover Advice

In a recent decision, the District Court of the Southern District of Iowa reviewed a motion to dismiss claims that the employees of a 401(k) plan administrator violated the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), by making misleading statements to plan participants in order to induce them into withdrawing their retirement savings out of their 401(k) plans and investing them in financial products sponsored by the plan administrator's affiliates. The plan participants alleged in their complaint that they were damaged as a result of their following the advice given by the plan administrator because they paid more in fees and earned less in the new financial products than if they had left their money in their employers' retirement accounts. The defendants filed a motion to dismiss the action on the grounds that the plan participants did not have standing to bring these claims under ERISA. The court held that the plan participants did not have standing under §1132(a)(2) of ERISA to assert their claim because standing under §1132(a)(2) requires that a plaintiff allege harm to an ERISA account. In this case, the alleged harm occurred with respect to the private investment accounts into which the assets were invested once withdrawn from the ERISA plans. However, the court ruled that the plaintiffs had standing under §1132(a)(3) of ERISA based on their assertion that the plan administrator owed them a fiduciary duty and had breached that duty by inducing the plaintiffs to transfer their assets out of their ERISA plans. The court noted earlier cases that established the principle that *former* ERISA plan participants may have standing under §1132(a)(3) if they were deceived into leaving their ERISA plans. Therefore, the court concluded that the plaintiffs alleged sufficient facts that, if taken as true, could demonstrate that the plan administrator owed them a fiduciary duty and breached that duty by causing plaintiffs to leave their ERISA plans. Because the plaintiffs' only claim for standing arose under §1132(a)(3), the remedies available to the plaintiffs were more limited than claims brought under other sections of ERISA. Under §1132(a)(3), the plaintiffs could only pursue equitable remedies such as injunctive relief, restitution or mandamus relief, and, depending on the facts of the case, disgorgement of profits and transfer of their assets back into their employers' retirement plans.

Broker-Dealer and Adviser Settle Enforcement Action Alleging Improper Inclusion of Affiliated Mutual Funds in Wrap Fee Account Program

In a recent order instituting enforcement proceedings (the "Enforcement Order"), the SEC alleged that a broker-dealer and its affiliated investment adviser violated Section 206 and 207 of the Advisers Act by making material misrepresentations to owners of certain discretionary mutual fund wrap fee accounts maintained by the broker-dealer. The Enforcement Order states that the broker-dealer hired the investment adviser to analyze and select the mutual funds to be included as investment options in the wrap fee program. According to the SEC, the promotional literature and other disclosures given to clients in connection with the program stated that the adviser's analysis would be based upon "an objective and unbiased research methodology" that followed a six-step screening process. However, the adviser allegedly omitted the first two screening steps, discounted the significance of quantitative analysis and emphasized subjective factors, which favored the proprietary funds sponsored by affiliates of the adviser. Although it did not admit or deny the allegations contained in the Enforcement Order, the broker-dealer agreed to a settlement with the SEC which included disgorgement of over $3,000,000 and civil monetary penalties in excess of $2,000,000. In addition, the adviser agreed to a settlement that required it to pay disgorgement of over $2,000,000 and civil monetary penalties of $1,000,000.

For further information, please contact your usual Ropes & Gray attorney.

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