update

Investment Management Update

ROPES & GRAY

Supreme Court Grants Certiorari in Janus Case

On June 28, 2010, the Supreme Court granted certiorari in *Janus Capital Group, Inc. v. First Derivative Traders* (No. 09-9525), to review the Fourth Circuit's decision which held that a mutual fund service provider can be primarily liable in a private securities-fraud action for "help[ing]" or "participating in" another company's misstatements in a prospectus.

The appeal arises out of an action alleging that Janus Capital Management, the adviser to the Janus funds, helped prepare prospectuses that contained misleading statements about the Janus funds' market timing policies. The prospectuses stated that the funds had policies discouraging market timing and that the funds took actions to deter such behavior. The complaint alleges that contrary to these statements, Janus Capital Management had, for several years, entered into secret agreements with hedge funds allowing them to engage in market timing in various Janus funds.

The District Court dismissed the complaint, holding that the plaintiffs failed to allege that Janus Capital Management "actually made or prepared the prospectuses, let alone that any statements contained therein were directly attributable to it" and that disseminating a misleading document is not "tantamount to making a misstatement for securities fraud purposes." The Fourth Circuit, however, reversed the District Court's decision holding that Janus Capital Management "made" the misleading statements in the prospectuses by participating in the writing, preparation and dissemination of the prospectuses. In its petition for certiorari, Janus argued that the Fourth Circuit's holding that a service provider can be *primarily* liable in a private securities-fraud action for helping or participating in the preparation of another company's misstatements contravenes decisions in the Fifth, Sixth and Eight Circuits. Janus further contends that Rule 10b-5 does not permit a private right of action for aiding and abetting securities fraud.

SEC Staff Provides Guidance to Registered Funds on Derivatives Disclosure

On July 30, 2010, the staff (the "Staff") of the Securities and Exchange Commission released a letter to the Investment Company Institute in which it expressed concerns over the adequacy of investment companies' derivatives disclosure. While the Staff has not concluded its broad review of funds' use of derivatives, the letter sets forth certain interim observations arising from that review.

The bulk of the letter describes the Staff's concerns with "generic" derivatives disclosure. According to the letter, Form N-1A disclosure framework aims to focus prospectus disclosure on principal investment strategies and risks, *i.e.*, those strategies the fund expects will be the most important and have a significant effect on performance, and attendant risk exposures. However, the Staff observed that "some funds provide generic disclosures about derivatives that, in our view, may be of limited usefulness for investors in evaluating the anticipated investment operations of the fund, including how the fund's investment adviser actually intends to manage the fund's portfolio and the consequent risks."

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The Staff criticizes both overly brief disclosure and lengthy/technical disclosure that is not *tailored to the fund*, and so does not provide useful information about the fund's actual/anticipated use of derivatives and resulting risk exposure. The letter indicates that a fund's disclosure should disclose the **anticipated types** of derivatives investments, the **anticipated purposes** for using derivatives and the **anticipated extent** of derivatives investment. However, in the Staff's view, many funds' disclosure merely enumerates all or virtually all types of derivatives as potential investments, provides non-specific disclosure about the purpose of the fund's use of derivatives (*e.g.*, by stating that derivatives may be used for "hedging or non-hedging purposes"), and does not indicate the expected extent of the fund's use of derivatives (*e.g.*, stating the fund may invest "all" of its assets in derivatives whether or not it expects to do so).

The Staff criticizes the "practice of … provid[ing] the same derivatives-related disclosures for multiple funds [within a complex], even though the various funds have different exposure to derivatives." Such generic disclosure "may not enable investors to distinguish which, if any, derivatives are in fact encompassed in the principal investment strategies of the fund or specific risk exposures they will entail."

The Staff also commented on the adequacy of backward-looking derivatives disclosure in shareholder reports. While mutual fund annual reports are required to include a Management's Discussion of Fund Performance (the "MDFP") discussing the factors materially affecting the fund's performance during the fiscal year, the Staff noted that certain shareholder reports of funds whose financial statements reflect significant derivatives usage contained little or no discussion of their impact.

The Staff also noted that providing qualitative information in Notes to Financial Statements about the usage and impact of derivatives during the covered period would improve disclosure from the standpoint of FASB Topic 815 ("Derivatives and Hedging") and Regulation S-X. In particular, funds that sell credit default swaps, which often disclose information about credit spreads, should explain the relevance of the size of the spread to the fund's economic exposure. In addition, given the counterparty risk involved in forward currency or swap contracts, the Staff's view is that the identities of relevant counterparties should be disclosed.

The Staff indicated that going forward its review will reflect the concerns outlined above. For example, in reviewing prospectuses it will "query whether the strategies listed are, in fact, principal investment strategies and whether the risk disclosure is tailored to those strategies," and cross-reference actual fund operations reflected in shareholder reports. It will similarly review shareholder reports and financial statements for adequacy of backward-looking discussion in the MDFP and elsewhere.

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California Unclaimed Property Law Imposes New Account Opening Disclosure Requirement

Effective January 1, 2011, California's Unclaimed Property Law will require banking and financial organizations (including investment companies) to provide written notice at the time an account is opened to all account owners that property in the account may be transferred to the state of California (or another state if required by law) if no activity occurs in the account within the time period specified by California law (or other state law, as applicable). Accounts that will be subject to such reporting requirements include accounts held by a financial organization that is domiciled *outside the state of California*, as well as a financial organization domiciled in California, if the account is owned by a person whose last known address is located in California. In addition, if the banking or financial organization is domiciled in California, the notice must be given to account owners whose last known address is (i) located in a foreign nation or (ii) located in a state that does not provide by law for escheat of such property, or (iii) unknown. Notice under this provision may be provided electronically, provided that the person opening the account has consented to receive electronic notice.

Certain 529 Plan Investments can be Omitted from Rule 204A-1 Access Person Reports

On July 28, 2010, the Staff published a no-action letter stating that it would not recommend enforcement action against a registered investment adviser for violating Section 204A of the Investment Advisers Act of 1940 (the "Advisers Act"), or Rule 204A-1 thereunder, if the investment adviser does not require its access persons to report transactions or holdings in qualified tuition programs established pursuant to Section 529 of the Internal Revenue Code ("529 Plans").

Rule 204A-1 provides that a registered investment adviser must establish, maintain, and enforce a written code of ethics that, among other things, requires the investment adviser's access persons to internally report transactions in and holdings of "reportable securities," as defined in Rule 204A-1(e)(10). The Staff concluded that, although investments in 529 Plans fall within the definition of reportable securities, the Staff would not recommend enforcement action because 529 Plans present little opportunity for the type of improper trading that access person reports are designed to uncover. The Staff clarified that the no-action relief would be applicable only if the investment adviser or a control affiliate does not manage, distribute, market, or underwrite the 529 Plan or the investments and strategies underlying the 529 Plan.

Likewise, the Staff stated that it would not recommend enforcement action if the investment adviser does not make and keep records related to its access persons' transactions and holdings in 529 Plans, as required by Section 204 of the Advisers Act and Rule 204-2 thereunder. Lastly, the Staff stated that the relief provided in the letter is also applicable to Rule 17j-1 under the Investment Company Act of 1940, which, among other things, requires access persons to report transactions and holdings in "covered securities."

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Further Changes to NY Power of Attorney Law

In 2009, New York State adopted certain amendments to Title 15 of the New York General Obligations Law ("Title 15") which prescribed requirements for powers of attorney executed by individuals in the State of New York (the "2009 NY POA Amendments"). The 2009 NY POA Amendments required that all such powers of attorney include certain extensive disclosures more appropriate to the estate planning context, be signed on behalf of the principal and the agent, and be notarized, among other things. They also provided that any such power of attorney would revoke all prior powers of attorney signed by the principal, unless otherwise stated in the new power of attorney. On August 13, 2010, New York enacted further amendments to Title 15 to exempt all powers of attorney given primarily for a business or commercial purpose from the onerous requirements of the 2009 NY POA Amendments. These further amendments will become effective on September 12, 2010, and will then be deemed to have been in effect on and after September 1, 2009, when the 2009 NY POA Amendments originally became effective. Once these amendments become effective, it will no longer be necessary to comply with the requirements of the 2009 NY POA Amendments for powers of attorney executed in connection with most typical investment management documents.

S.D.N.Y. Dismisses ERISA Investment Misrepresentation Claim Against Directed Trustee, Allows Claim to Proceed Against Administrative Service Provider

On August 12, 2010, Southern District of New York Judge Richard J. Holwell issued an opinion in *F.W. Webb Co. v. State Street Bank and Trust Co.,* dismissing an ERISA claim against a retirement plan's directed trustee based on alleged investment misrepresentations, but allowing an analogous claim to go forward against the plan's administrative service provider. Plaintiff F.W. Webb Company ("Webb") brought the ERISA action on behalf of its 401(k) employee retirement plan (the "Plan") against State Street Bank & Trust Company ("State Street"), the Plan's directed trustee, and CitiStreet LLC ("CitiStreet"), the Plan's administrative service provider. Webb alleged that the defendants had misrepresented the strategy and risks of the SSgA Yield Plus Fund (the "Fund"), a mutual fund made available by the defendants for the Plan to include in its 401(k) menu that declined in value during the mortgage market crisis in 2007. First, citing the Seventh Circuit's recent decision in *Hecker v. Deere & Co.*, 556 F.3d 575, 583 (7th Cir. 2009), the Court determined that the defendants' alleged roles in making available a standard "big menu" of funds from which the Plan selected its "small menu" of 401(k) investment options did not alone entail sufficient discretionary control to confer fiduciary status on either defendant. Second, the Court held that Webb sufficiently alleged an ERISA claim against CitiStreet as an investment advisor fiduciary to the Plan, but it failed to state a claim against State Street in that regard. Specifically, the Court held that although neither defendant contracted with Webb to provide investment advice, allegations that CitiStreet nevertheless provided such advice and made material misrepresentations regarding the Fund sufficed to state a claim under ERISA. In dismissing Webb's claim against State Street, the Court held that State Street's alleged failure to correct or prevent CitiStreet's purported misrepresentations did not suffice to state a claim that State Street had violated its "narrow" set of fiduciary duties as a directed trustee. Ropes & Gray represents State Street in this matter.

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Other Developments

Since the last issue of our IM Update we have also published the following separate Client Alert(s) of interest to the investment management industry:

- SEC Adopts Advisers Act Rule Addressing "Pay to Play" Practices - July 9, 2010
- The Impact of Financial Reform: Framework Established for Liquidating Failed Financial Companies - July 21, 2010
- The Impact of Financial Reform: Private Fund Investment Adviser Registration - July 21, 2010
- The Impact of Financial Reform: The Federal Regulation of OTC Derivatives - July 21, 2010
- The Impact of Financial Reform: Banking, the Volcker Rule, Executive Compensation, and Corporate Governance - July 21, 2010
- The Impact of Financial Reform: Bounty Available for Whistleblowers Who Reveal Violations of Federal Securities Laws, Including the Foreign Corrupt Practices Act - July 21, 2010
- The Impact of Financial Reform: Effects on Investment Companies and Investment Advisers of the Dodd-Frank Wall Street Reform and Consumer Protection Act - July 21, 2010
- SEC Proposes New Rule and Related Amendments to Replace Rule 12b-1 - July 29, 2010
- Dodd-Frank Financial Reform Legislation Contains Many Little-Noticed Provisions that Enhance SEC Enforcement Powers - August 5, 2010
- New ERISA Fee Disclosure Rules - August 2010
- SEC Adopts Amendments to Form ADV Part 2 – August 11, 2010
- The SEC Swiftly Adopts Proxy Access Rules Following Authorization Under the Dodd-Frank Act - August 26, 2010
- Massachusetts Supreme Judicial Court Affirms Application of Business Judgment Rule to Mutual Fund Board's Decision to Dismiss Shareholder Derivative Suit - August 26, 2010

For further information, please contact the Ropes & Gray attorney who normally advises you.

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