Investment Services Regulatory Update

December 1, 2011

LITIGATION

District Court Permits Shareholder Litigation Against Oppenheimer to Continue

On October 24, 2011, the U.S. District Court for the District of Colorado denied the motion to dismiss of seven Oppenheimer municipal bond funds, their advisers and trustees (the "Oppenheimer defendants") with respect to the shareholder plaintiffs' claims asserted under the Securities Act. The plaintiffs generally alleged that the funds' prospectuses misrepresented the funds' investment strategies and failed to disclose the nature and magnitude of the risks associated with the funds' derivative and other highly illiquid and volatile holdings, including, in particular, investments in inverse floaters, in violation of Sections 11 and 12(a)(2) of the Securities Act. The net asset values of the funds held by the plaintiffs fell between 30%-50% during the credit crisis in 2008. The Oppenheimer defendants moved to dismiss on the grounds that the complaint failed to establish the existence of any untrue or misleading statements or omissions of material fact in the funds' prospectuses and that the plaintiffs could not establish loss causation. The court disagreed and allowed the plaintiffs' claims under the Securities Act to proceed.

The plaintiffs alleged that the characterization of the funds as "conservative" and of the funds' "capital preservation" objective were misleading. The court noted that whether the statements are actionable must be determined based on the context provided by the funds' prospectuses and other disclosures. It further stated that, the assurance of "capital preservation" went beyond "puffery" by the Oppenheimer defendants and amounted to a description of a material feature of the funds upon which reasonable investors might rely. The court noted that the term "capital preservation" has a meaning that investors' capital will be protected from loss, and that the prospectuses failed to adequately disclose that investors' would be subject to loss of capital if market conditions changed.

The plaintiffs further alleged that the funds' use of inverse floaters was inconsistent with the funds' objective of capital preservation and that the corresponding risks were not adequately disclosed. The plaintiffs alleged that the prospectuses did not disclose the extent to which the inverse floaters were leveraged and how sensitive they were to market changes, including that certain market changes could cause inverse floaters to take on a negative value and cause the devaluation of the long-term bonds underlying them. The court disagreed with the Oppenheimer defendants' arguments that they were under no duty to disclose the leverage ratios of the inverse floaters. The court stated that, once disclosures were made regarding a certain type of investment, it was the duty of the defendants to ensure that the disclosure was neither directly misleading nor misleading by omission. The court also noted that some of the disclosure provided regarding inverse floaters was directly misleading. In one instance, the court noted that the prospectuses stated that "an inverse floater with a higher degree of leverage *usually* [emphasis added] is more volatile … than an inverse floater with a lower degree of leverage." However, as the court noted, by definition, an inverse floater with higher leverage is *always* more volatile.

With respect to loss causation, the Oppenheimer defendants argued that while loss causation is an affirmative defense under Sections 11 and 12(a)(2) of the Securities Act, it may be considered on a motion to dismiss "where the absence of loss causation is apparent on the face of the complaint." The defendants argued that when determining the amount of damages under Sections 11 or 12(a)(2), the depreciation caused by things "other than" the misleading statements must be omitted from the amount and that, in the context of a fund, depreciation is always the result of things "other than" misleading statements because of the way fund shares are priced. According to the defendants, because a fund's NAV per share is determined by using the prices of the underlying securities held in the portfolio, neither investor expectations about the fund nor the information that shapes those expectations can impact the fund's NAV per share. In considering this argument, the court noted, that if the Oppenheimer defendants' view was followed, funds would be categorically excluded from liability under Sections 11 and 12(a)(2). In ruling in favor of the plaintiffs on this point, the court concluded that the plaintiffs' losses were plausibly linked to the alleged misrepresentations and omissions in the funds' prospectuses.

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Adopts Reporting Obligations for Advisers to Private Funds

On October 26, 2011, the SEC adopted Rule 204(b)-1 under the Advisers Act, to implement certain reporting requirements under the Dodd-Frank Act. Rule 204(b)-1 requires investment advisers registered with the SEC that advise one or more private funds and have at least $150 million in private fund assets under management ("private fund advisers") to periodically file new Form PF with the SEC. Information collected by the SEC on Form PF is intended to assist the Financial Stability Oversight Council in monitoring systemic risk in U.S. financial markets. The information provided on Form PF will be confidential.

The content and frequency of a private fund adviser's reporting obligations will vary based on the adviser's size and types of funds managed. Private fund advisers deemed "large private fund advisers" who must provide additional disclosure are those with (1) at least $1.5 billion in assets under management attributable to hedge funds; (2) at least $1 billion combined in assets under management attributable to liquidity funds and registered money market funds; or (3) at least $2 billion in assets under management attributable to private equity funds. All other private fund advisers filing Form PF are considered "smaller private fund advisers."

Smaller private fund advisers must file Form PF only once a year, within 120 days of their fiscal year end, and only basic information about the private funds advised is required. The information required includes the size, leverage, investor types and concentration, liquidity and performance of the funds. Smaller advisers of hedge funds must also include certain information about the strategy, counterparty credit risk and use of trading and clearing mechanisms.

The filing requirement for large private fund advisers varies depending on the type of funds advised:

- Large hedge fund advisers must file Form PF within 60 days of the end of each fiscal quarter. The disclosure must include, on an aggregate basis, information regarding exposure by asset class, geographical concentration and turnover by asset class. For a hedge fund with net assets of at least $500 million, large advisers are required to report certain information relating to that fund's exposure, leverage, risk profile and liquidity.

- Large liquidity fund advisers must file Form PF within 15 days of the end of each fiscal quarter. The disclosure must include information on the types of assets in each of their liquidity fund's portfolios, certain information relevant to the risk profile of the fund and the extent to which the fund has a policy of complying with all or aspects of Rule 2a-7 under the 1940 Act.

- Large private equity fund advisers must file Form PF annually within 120 days of their fiscal year end. The disclosure must include information regarding the extent of leverage incurred by their funds' portfolio companies, the use of bridge financing and their funds' investments in financial institutions.

Compliance with Form PF filing requirements will be implemented in two stages. A private fund adviser with $5 billion or more in assets under management attributable to either hedge funds, liquidity funds or private equity funds must file Form PF following its first fiscal year or fiscal quarter, as applicable, ending on or after June 15, 2012. For all other private fund advisers, the filing requirements begin following their first fiscal year or fiscal quarter, as applicable, ending on or after December 15, 2012.

OTHER NEWS

PCAOB Issues Concept Release on Auditor Independence and Audit Firm Rotation

In August 2011, the Public Company Accounting Oversight Board ("PCAOB") issued a concept release requesting comments on possible approaches to enhance auditor independence, objectivity and professional skepticism. As background to the concept release, the PCAOB noted that, although the reform provisions of the Sarbanes-Oxley Act of 2002 have improved auditor independence, the PCAOB had found instances in which it appeared that auditors have failed to approach audits with the required level of independence, objectivity and professional skepticism. The concept release, while seeking comments on enhancing auditor independence generally and on the various approaches the PCAOB could take to make such enhancements, focused primarily on a proposal to require mandatory audit firm rotation.

Proponents of mandatory audit firm rotation claim that limiting the number of consecutive years an audit firm can provide audit services to a client, and thereby also limiting the long-term income streams the auditor receives from such client, may strengthen the auditor's ability to resist management pressure, allow for a fresh viewpoint that a new independent auditor may bring to the audit process and provide incentive to ensure that the audit is done correctly. Opponents have expressed concerns over the potential costs that changing auditors could impose on issuers, that rotation could negatively affect audit quality in the early years of an engagement because of the steep learning curve new auditors face to gain the requisite knowledge of issuers that is necessary for effective audits and that there may be an issue with issuers being able to find audit firms with the necessary capacities, areas of expertise and independence.

The concept release, acknowledging the various viewpoints, solicits comments generally on auditor independence and more specifically on the mandatory audit firm rotation proposal. In particular, the PCAOB poses 21 questions on the rotation proposal covering topics such as: (1) the appropriate length for an audit firm’s term, (2) whether the rotation requirement should apply only to certain types of issuers, (3) implementation concerns, including possible challenges or unintended consequences of the rotation proposal, and (4) whether the PCAOB should consider changing other requirements to mitigate any risks posed by rotation, such as requiring firms to provide additional audit supervision and oversight at the beginning of an engagement or restricting an issuer’s ability to remove an auditor before the end of a fixed term.

Comments on the concept release are due by December 14, 2011. The PCAOB announced that it will convene a roundtable meeting in March 2012 to discuss auditor independence and mandatory audit firm rotation.

ICI and IDC Issue White Paper on Board Oversight of Risk Management

In September 2011, the ICI and IDC issued a paper, “Fund Board Oversight of Risk Management,” to assist fund directors in understanding and fulfilling their risk management oversight responsibilities. The paper provides an overview of risk management, fund risks, the different roles that boards and advisers have regarding risk management, and current industry practices. The paper underscores that a board’s role is oversight, there is no single set of best practices for board oversight of risk management, practices continue to evolve and a board should develop its oversight of risk management in a manner that complements its structure and practices.

Risk Management. According to the paper, regardless of how the risk management function is structured, there are recurring themes that may impact a board’s consideration of risk management processes. These themes include: (1) senior management’s creation of a risk-conscious culture in the organization (i.e., the “tone at the top"); (2) the ongoing nature of risk management; (3) each level within an organization is responsible for risk management; (4) the benefits of a process for independent review of risk controls, assumptions and models; (5) risk management programs should focus on identifying potential material risks to the fund, the likelihood of such risks occurring and the potential impact of such risks, as well as preventing recurrence of past challenges; (6) the importance of clear communication and collaboration among various control functions (including risk management, legal, compliance and internal audit) and business lines; and (7) balancing the segregation of control functions from business lines while encouraging collaboration.

Fund Risks. The paper stresses that boards and advisers should have a clear and mutual understanding of risk-related terminology and of the types and levels of risk appropriate for their funds.

Roles of Boards and Advisers Regarding Risk Management. According to the paper, boards and advisers have a common goal in minimizing fund risks, but play two different roles; advisers are responsible for managing the funds' risks, while a board's role is oversight. The paper notes that by fulfilling their regulatory oversight responsibilities with respect to contract approval, fair valuation and oversight of the fund's compliance program, directors help mitigate fund risks. The paper states that board oversight with respect to a fund, in general, encompasses:

- establishing a common understanding with the adviser as to the sources and levels of risk appropriate for the fund;
- being aware of the most significant risks to the fund and the steps being taken to manage those risks;
- understanding the current risk management processes, asking questions where appropriate and obtaining appropriate assurances that the processes are reasonably designed to manage and control the fund's material risks; and
- encouraging and reinforcing a strong "tone at the top" at the adviser by, among other things, sustaining an appropriate focus on risk management.

Risk Management Practices. The paper states that an effective risk management program may be structured in many ways, but that various levels within an organization are responsible for risk management (i.e., from individuals responsible for managing and reporting on day-to-day risks to those overseeing the various business units' risk management activities to senior officers of the adviser who are responsible for managing risks and the adviser's board of directors, which may oversee the adviser's risk management program). Additionally, the paper states that advisers may employ various tools and processes to identify, assess, manage and document fund risks, including risk assessments, stress testing and escalation procedures.

Board Practices. Board practices vary in terms of whether a board as a whole or various committees of the board oversee fund risk, what types of risk-related reports boards receive and the types of educational sessions boards have on risk management. The paper suggests that a board may periodically review its risk oversight processes to ensure their continued effectiveness by (1) including risk oversight in the board's annual self-evaluation of effectiveness, (2) considering risk management as part of any long-term strategy or planning session, (3) seeking feedback on the board's risk oversight approach from third parties and/or (4) encouraging directors to participate in continuing education opportunities.

The paper is available at: www.ici.org/pdf/pub_11_oversight_risk.pdf.

SEC Staff Issues "Pay-to-Play" No-Action Relief for Advisers to Registered Funds

On September 12, 2011, the SEC staff issued a no-action letter stating that the Division of Investment Management would not recommend enforcement action under the "pay-to-play" recordkeeping requirements of the Advisers Act against investment advisers to registered funds that comply with alternative recordkeeping requirements. Under the "pay-to-play" recordkeeping requirements, an investment adviser is required to maintain records of all government entities that are, or were, investors in any covered investment pool (including registered funds) to which the adviser provides, or has provided, investment advisory services in the past five years, but not prior to September 13, 2010.

In recognition that a government entity may hold shares of a registered fund through one or more omnibus accounts, the SEC staff granted no-action relief from the "pay-to-play" recordkeeping requirements applicable to an investment adviser to a registered fund that is an investment option of a plan or program of a government entity (a "Covered Investment Pool"). In order to rely on the no-action relief, an investment adviser to a Covered Investment Pool is required to make and maintain a list or other record that includes:

- each government entity that invests in a Covered Investment Pool, where the account of the government entity can reasonably be identified as being held in the name, or for the benefit, of the government entity on the records of the Covered Investment Pool or its transfer agent;

- each government entity, the account of which was identified as that of a government entity—at or around the time of the initial investment—to the adviser or one of its client servicing employees, regulated persons or covered associates (all as defined in the no-action letter or the "pay-to-play" rule);

- each government entity that sponsors or establishes a 529 plan and has selected a specific Covered Investment Pool as an option to be offered by the 529 plan; and

- the government entity that has been solicited to invest in a Covered Investment Pool either by (1) a covered associate or regulated person of the adviser; or (2) an intermediary or affiliate of the Covered Investment Pool if a covered associate, regulated person or client servicing employee of the adviser participated, or was involved, in the solicitation, regardless of whether the government entity invested in the Covered Investment Pool.

The no-action letter specifically notes that, for purposes of the granted relief, a Covered Investment Pool does not include any company that would be an investment company but for the exclusions provided by Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the 1940 Act. The no-action letter also notes that the granted relief only applies to the portion of the "pay-to-play" recordkeeping requirements relating to Covered Investment Pools, and investment advisers are otherwise required to make and maintain a list of all government entities to which the adviser provides, or has provided, investment advisory services.

ENFORCEMENT ACTIONS

SEC Settles Charges Against Morgan Stanley Investment Management for Improper Subadvisory Fee Arrangement

On November 16, 2011, the SEC charged Morgan Stanley Investment Management Inc. (MSIM) with violating federal securities laws in connection with subadvisory fees improperly charged to The Malaysia Fund, a closed-end fund for which MSIM served as investment adviser and administrator. The SEC alleged that MSIM entered into a subadvisory agreement with a Malaysian subadviser to provide advice, research and assistance to the fund, but that, in practice, the Malaysian subadviser merely provided two monthly reports based on publicly available information that MSIM neither requested nor used in its management of the fund. The SEC's order stated that, in renewing the subadvisory agreement each year, the fund's board relied on information provided by MSIM, including an annual report from the Malaysian subadviser representing that it provided: (1) research on Malaysian companies that MSIM used to identify investment opportunities; (2) statistical reports to assist MSIM's investment decisions; (3) market intelligence on Malaysian corporate developments; and (4) advice on changes in the economic and political conditions in Malaysia. According to the SEC, the fund paid more than $1.8 million in fees from 1996 to 2007 to the Malaysian subadviser.

The SEC alleged that MSIM violated (1) Section 15(c) of the 1940 Act by failing to provide the fund's board with information reasonably necessary to evaluate the nature, quality and cost of the Malaysian subadviser's services; (2) Section 206(2) of the Advisers Act by representing to the fund's board that the Malaysian subadviser was providing advisory services when it was not; (3) Section 206(4) of the Advisers Act by failing to adopt and implement procedures governing the oversight and review of the work performed by the Malaysian subadviser; and (4) Section 34(b) of the 1940 Act by preparing and distributing shareholder reports with materially false and misleading statements regarding the services provided by the Malaysian subadviser. MSIM agreed to repay the $1.8 million of subadvisory fees charged to the fund during the relevant period, as well as pay a $1.5 million penalty. MSIM further agreed to implement and maintain improved policies and procedures governing the 15(c) process and its oversight of subadvisers.

SEC Orders FINRA to Hire Independent Consultant and Undertake Remedial Measures Related to Records Integrity and Document Production

On October 27, 2011, the SEC ordered FINRA to engage an independent consultant and undertake other remedial measures with respect to its policies, procedures and training for document production during SEC inspections. According to the SEC's order, in August 2008, the director of FINRA's Kansas City district office altered minutes for three staff meetings hours before producing the minutes to SEC inspection staff. In connection with the SEC's findings, FINRA agreed to provide additional training and instruction to all employees regarding document integrity, and to engage an independent consultant to (1) conduct a review of FINRA's policies, procedures and training relating to document integrity; (2) assess whether the policies, procedures and training are reasonably designed and implemented to ensure the integrity of documents provided to the SEC; and (3) make recommendations for improvements to FINRA's policies, procedures and training.

SEC Charges Former Goldman Sachs Employee and His Father with Insider Trading in Securities Underlying an ETF

On September 21, 2011, the SEC charged Spencer Mindlin, a former Goldman, Sachs & Co. employee, and his father with insider trading with respect to confidential trading strategies and information that he learned while working on Goldman's ETF desk. The SEC alleged that Mr. Mindlin learned of and shared with his father information regarding Goldman's plans to purchase and sell large amounts of securities underlying the SPDR S&P Retail ETF ("XRT").

During the relevant period, Goldman allowed its customers to short the XRT and as a result, according to the SEC's order, was the largest institutional holder of the XRT. In addition, in order to hedge its own exposure, Goldman shorted the individual securities underlying the XRT. The SEC alleged that by virtue of his position on Goldman's ETF desk, Mr. Mindlin was aware of Goldman's non-public position in the XRT and was aware of Goldman's intentions to trade large amounts of securities underlying the XRT in order to hedge its position in the XRT. According to the SEC, Mr. Mindlin and his father placed multiple trades on inside information and obtained at least $57,000 in illicit profits.

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