Investment Services Regulatory Update

January 3, 2012

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 New Net Worth Standard for Accredited Investors

On December 21, 2011, the SEC adopted an amendment to the definition of "accredited investor" in order to implement Section 413(a) of the Dodd-Frank Act. The SEC adopted the amendment substantially as proposed on January 25, 2011, with some changes made in response to comments. Specifically, the SEC adopted amendments to Rules 215 and 501(a)(5) under the Securities Act to exclude the value of a natural person's primary residence for purposes of determining whether a natural person is an "accredited investor" (i.e., has a net worth in excess of $1 million). The amended definition also includes a grandfathering provision to permit the application of the former definition in certain limited circumstances and a provision addressing the treatment of incremental debt secured by the primary residence that is incurred within 60 days of the sale of securities to the individual. The amended definition of "accredited investor" becomes effective on February 27, 2012.

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.

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.

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This Regulatory Update is only a summary of recent information and should not be construed as legal advice.