Investment Services Regulatory Update

July 2, 2012

LEGISLATION

Representatives Bachus and McCarthy Introduce the Investment Adviser Oversight Act of 2012

On April 25, 2012, Representative Spencer Bachus (R-Ala.), Chairman of the House Financial Services Committee, and Representative Carolyn McCarthy (D-N.Y.), a member of the Committee, introduced the Investment Adviser Oversight Act of 2012. The proposed legislation would amend the Advisers Act to provide for the creation of one or more National Investment Adviser Associations (SROs), to be registered with and overseen by the SEC, and require that each SEC- and state-registered investment adviser, unless exempt, become a member of an SRO. The bill would exempt from the SRO membership requirement advisers that (1) advise one or more registered investment companies or (2) have total assets under management at least 90% of which are attributable to one or more of the following clients: (a) non-U.S. investors; (b) qualified purchasers (as defined in the 1940 Act); (c) private funds; (d) collective trust funds; (e) charitable investment funds; or (f) other institutional clients, such as mortgage REITs, issuers of asset-backed securities, employee securities companies or business development companies. Investment advisers that are affiliated with an exempt adviser could also claim an exemption from the SRO membership requirement if 90% or more of the combined assets under management of the exempt adviser and the affiliated adviser are attributable to the clients listed above. The bill provides, however, that the SEC may determine that an affiliate is an "independent affiliate" that has "compliance programs, operations and businesses that are sufficiently independent" from those of the exempt adviser such that membership of the independent affiliate in an SRO is necessary for the protection of investors. The proposed legislation would also grant an SRO the authority to conduct examinations of its members, provided that state-registered advisers that maintain their principal office and place of business in a state that adopts a plan to conduct on-site examinations every four years generally would be exempt from SRO examinations. Under the bill, an SRO would have the authority to enforce the provisions of the Advisers Act and the rules thereunder. Finally, the bill would allow an SRO to adopt its own rules, subject to the approval of the SEC after notice, a comment period and a cost-benefit analysis performed by the SRO.

LITIGATION

ICI and U.S. Chamber of Commerce File Lawsuit Challenging CFTC Amendments to Rule 4.5

On April 17, 2012, the ICI and the U.S. Chamber of Commerce filed a lawsuit against the Commodity Futures Trading Commission challenging the legality of recently enacted amendments to CFTC Rule 4.5. As amended, the rule reinstates certain restrictions on registered investment companies' use of futures contracts and derivatives in effect prior to 2003, and requires CFTC registration for investment advisers to registered investment companies that engage in non-hedging commodity trading above certain thresholds or registered investment companies marketing themselves as vehicles for trading in the commodities markets.

The lawsuit, filed in the U.S. District Court for the District of Columbia, challenges the Rule 4.5 amendments by alleging that the CFTC failed to discharge its statutory obligations under both the Commodity Exchange Act and the Administrative Procedure Act when enacting new rules. Specifically, the complaint alleges that the amendments to Rule 4.5 are arbitrary and capricious in that they are unnecessary, redundant and costly for registered investment companies and requests injunctive relief to prevent the CFTC from implementing amended Rule 4.5. In support of their position, the ICI and the U.S. Chamber of Commerce allege numerous defects in the rulemaking process, including the CFTC's failure to discharge its obligations to:

- Perform the required cost-benefit analysis of the impact of the amended rule as required by the Commodity Exchange Act.
- Provide the public with sufficient opportunity to participate in the rule-making process as required under the Administrative Procedure Act.
- Explain the benefits to be derived from the amended rule above those already provided to investors through existing regulation, as well as explain the reversal of the CFTC's 2003 determination that regulation of investment companies was unnecessary, burdensome and impaired liquidity.
- Provide adequate justification for the increased regulatory requirements, obligations and restrictions that the amended rule would impose on registered investment companies.

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Staff Provides Informal Guidance to ICI on Fund Names Using "International" and "Global"

On June 4, 2012, the ICI published a memorandum summarizing informal guidance provided by the SEC staff on their position regarding the use of "international" and "global" in fund names. The ICI sought the guidance in response to inquiries from industry participants about the staff's current views on fund names using these terms. The ICI noted that, while the 2001 adopting release for Rule 35d-1 under the 1940 Act (the "Names Rule") stated that the "terms 'international' and 'global'…connote diversification among investments in a number of different countries throughout the world…and will not be subject to [Rule 35d-1]," the SEC staff expressed their views that they are authorized by Section 35(d) of the 1940 Act and Rule 35d-1 to evaluate all fund names, including those not covered by Rule 35d-1. With respect to funds using "international" and "global" in their names, the staff indicated to the ICI that SEC reviewers have been instructed to request that these funds expressly describe how they will invest their assets in investments that are tied economically to a number of countries throughout the world. The SEC staff provided the ICI with suggestions on how funds might satisfy this mandate, such as stating that the fund would invest at least 40% (30% during unfavorable conditions) of its assets outside the U.S. and in at least three different countries, or, alternatively, stating that the fund will invest "primarily" or a "majority of its assets" in non-U.S. securities. The SEC staff also indicated to the ICI that, if other language is used by a fund, such as a statement that the fund's non-U.S. investments will be in proportion to its benchmark index's weighting, the fund's reviewer is expected to consider whether such methodology effectively connotes the appropriate level of non-U.S. investments.

FINRA Adopts Amended Rules Regarding Member Communications with the Public

In June 2012, the SEC announced that it had approved FINRA's proposed amendments to rules governing communications by its member firms with the public.

Under current NASD Rule 2210, communications with the public are divided into six categories—advertisements, sales literature, correspondence, institutional sales material, independently prepared reprints, and public appearances, each of which has its own pre-approval, filing and contents standards. Pursuant to the final rules, the number of categories has been reduced to three and consist of:

- "Institutional Communications" – written or electronic communications that are distributed or made available only to "institutional investors," but do not include a firm's internal communications.

- "Retail Communications" – any written or electronic communication that is distributed or made available to more than 25 "retail investors" within any 30 calendar-day period. Communications that fall under the current categories of "advertisements" and "sales literature" will generally be treated as retail communications. Additionally, any communication that currently qualifies as an "independently prepared reprint" that is distributed to more than 25 retail customers in a 30 calendar-day period will be considered a retail communication.

- "Correspondence" – any written or electronic communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period.

The amended rules revise the categories of communications subject to the pre-use filing requirements of current NASD Rule 2210(c)(4) to include retail communications concerning any registered investment company that include (1) self-created rankings, (2) information concerning security futures and (3) bond mutual fund volatility ratings.

The amended rules also revise the categories of communications that must be filed within 10 business days of first use or publication to include all retail communications concerning closed-end funds.

In addition, new Rule 2210(d)(7)(C) changes the current provisions governing communications that include past recommendations to align with Rule 206(4)-1(a)(2) under the Advisers Act. New Rule 2210(d)(7)(D) expressly excludes from these requirements communications that meet the definition of a "research report" under current NASD rules, and also excludes any communication that recommends only registered investment companies or variable insurance products, provided that the communications were supported by a reasonable basis for their recommendation.

The amended rules become effective on February 4, 2013.

Federal Reserve Board Clarifies Volcker Rule Compliance Deadline

On April 19, 2012, the Federal Reserve Board approved a statement clarifying that banking entities have until July 21, 2014 to fully comply with Section 619 of the Dodd-Frank Act (commonly known as the "Volcker Rule") and any rules adopted to implement the Volcker Rule. The Volcker Rule imposes certain prohibitions and restrictions on a banking entity's ability to engage in proprietary trading and maintain interests in hedge funds and private equity funds. The Federal Reserve Board's statement provides registered investment companies with additional time to determine how they may be affected by the implementation of the Volcker Rule. The SEC and other federal agencies have proposed a joint rule to implement the Volcker Rule.

OTHER NEWS

Mutual Fund Directors Forum and eSecLending Issue Practical Guidance on Securities Lending Programs

In May 2012, the Mutual Fund Directors Forum and eSecLending issued separate reports providing an overview of securities lending practices and offering guidance on the oversight and implementation of securities lending programs. The MFDF report focused on providing fund boards with guidance on evaluating proposals to implement securities lending programs and overseeing such programs. The eSecLending report focused on providing guidance to fund management for creating, monitoring and managing securities lending programs. The reports included the following guidance:

- Whether a fund can lend securities and the extent to which it may do so should be established in a board-approved securities lending policy. Such a policy may include the objectives of the securities lending program, criteria to determine appropriate borrowers, preferred routes to market (e.g., using a custodian, third party, principal exclusive or other type of model), securities lending restrictions, proxy voting guidelines on loaned securities, collateral guidelines and reinvestment guidelines.

- As part of determining whether to approve a securities lending program, boards should understand the costs and benefits of the program, any tax implications of the program, how collateral received in connection with loaned securities will be invested and what service providers fund management will use to implement the program.

- Boards should also understand the risks of securities lending, such as operational risks, counterparty risks, reinvestment risk, market risk and liquidity risk, among others, as well as the policies and procedures fund management has implemented to identify, monitor and mitigate such risks.

- Boards should initially approve the contracts with the service providers that will implement and manage the securities lending program. Boards should also review the performance and fees of the service providers on an ongoing basis and consider whether the fees remain appropriate in light of the services provided.

- Once a securities lending program is in place, the board, with the assistance of the fund's chief compliance officer, should review the program on a regular basis. Fund management should regularly provide the board with reports about the securities lending program that include the performance of the program, as well as a review of compliance, risk management, operational information, collateral reinvestment, income earned and performance benchmarking. Fund management should provide the board with market color that discusses the strategies and interest for individual securities and asset classes to enhance the board's understanding of what is driving the demand for the fund's securities.

- Fund management should consider forming a working group comprised of management personnel responsible for monitoring the securities lending program and performing due diligence on the service providers.

- When deciding on a specific route to market and which lending agent to use, fund management should conduct proper due diligence, and ensure that the lending agent provides a comprehensive trading strategy for fund securities and that the lending agent understands the fund's preferences for proxy voting and security restrictions.

- Fund management should conduct thorough due diligence of a lending agent's collateral management process. Fund management should understand the lending agent's operational processes around collateralization and what rights the fund will have to the collateral in the event of a borrower default.

The reports are available at the following websites:

MFDF Report:
http://www.mfdf.org/images/uploads/newsroom/Board_Oversight_of_Securities_Lending_May_2012.pdf

eSecLending Report:
http://www.eseclending.com/pdfs/Securities%20Lending%20Best%20Practices%20Mutual%20Funds%202012.pdf.

ENFORCEMENT ACTIONS

SEC Settles Charges Against Oppenheimer for Misleading Statements Regarding Derivatives Use and Exposure During Financial Crisis

On June 6, 2012, the SEC charged OppenheimerFunds, Inc. and OppenheimerFunds Distributor, Inc., the investment adviser and distributor, respectively ("Oppenheimer"), of the Oppenheimer Champion Income Fund and Oppenheimer Core Bond Fund, with violating federal securities laws for making misleading statements relating to the funds' use of total return swaps during the credit crisis in late 2008. The SEC alleged that the funds' significant underperformance relative to their peers in 2008 was attributable primarily to their substantial exposure to AAA-rated commercial mortgage-backed securities (CMBS) achieved principally through total return swaps, despite prospectus disclosure, with respect to the Champion Fund, that indicated that its investment returns would mainly be a function of the fund's investments in high-yield bonds. The SEC's order stated that the prospectus disclosure neither adequately disclosed that the Champion Fund could use derivatives to such an extent that its total investment exposure could far exceed the value of its portfolio securities nor conveyed the heightened risk of loss associated with leverage. The SEC order stated that this risk of loss from levered exposure to CMBS was realized when, in late 2008, as the market values for both funds' portfolio securities were falling and driving down the funds' net asset values, the CMBS market crashed, triggering large liabilities on the funds' total return swaps and forcing the funds, particularly the Champion Fund, to sell large portions of their depressed portfolio securities into an increasingly illiquid market in order to meet those liabilities. Despite these developments and a determination by Oppenheimer management to reduce the funds' CMBS exposure, the SEC alleged that Oppenheimer advanced materially misleading communications to sales personnel, financial advisers and shareholders, characterizing the funds' losses as "paper losses," not "permanent impairments," suggesting that the funds could still make back all of their CMBS losses and purporting to remain committed to CMBS investments, with no change in the funds' holdings or strategies. These misleading communications were of critical importance, according to the SEC order, since, along with the misleading prospectus disclosure, the communications regarding the funds' investment program and prospects enabled Oppenheimer to retain existing fund shareholders and attract new ones and, thus, continue to benefit in the form of management fees paid by the funds.

The SEC found that Oppenheimer violated (1) Section 34(b) of the 1940 Act by making materially misleading statements in the Champion Fund's prospectus by describing the fund's "main" investments without adequately disclosing the fund's practice of assuming substantial leverage on top of those investments; (2) Section 206(4) of the Advisers Act and Rule 206(4)-8(a) thereunder by disseminating misleading statements about the funds in the midst of their precipitous NAV declines in late 2008; and (3) Sections 17(a)(2) and 17(a)(3) of the Securities Act by obtaining money in the offer or sale of the Champion Fund's shares by means of the misleading prospectus and disseminating misleading statements about the funds. Oppenheimer agreed to pay a penalty of $24 million, disgorgement of $9,879,706 and prejudgment interest of $1,487,190.

Four Firms Sanctioned by FINRA for Sales of Leveraged and Inverse ETFs

On May 1, 2012, FINRA announced that it imposed more than $9 million in fines against Citigroup Global Markets, Inc., Morgan Stanley & Co., LLC, UBS Financial Services and Wells Fargo Advisors, LLC for practices related to sales of leveraged and inverse ETFs. According to FINRA, the firms failed to maintain a reasonable supervisory system over the sale of these "non-traditional" ETFs. FINRA also found that these firms failed to provide adequate training to educate registered representatives about these funds and failed to perform reasonable diligence to understand the nature of these funds, including the potential risks and rewards.

According to FINRA, leveraged and inverse ETFs expose customers to risk of performance when held for longer periods of time in volatile markets. Notwithstanding these risks, FINRA found these firms supervised their customers' investments in non-traditional ETFs in the same manner as traditional ETFs. As a result, FINRA found that these firms made unsuitable recommendations to customers to purchase leveraged and inverse ETFs, some of which continued to hold these securities for extended periods of time despite their conservative risk tolerance profiles and extreme market volatility. The sanctions announced by FINRA consisted of $7.3 million of fines and $1.8 million in restitution to certain customers.

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