Investment Services Regulatory Update

September 4, 2012

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Proposes Rules to Implement JOBS Act Provisions for Elimination of Prohibitions Against General Solicitation in Private Offerings

On August 29, 2012, the SEC proposed amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act in order to implement Section 201(a) of the Jumpstart Our Business Startups Act ("JOBS Act"). Section 201(a)(1) of the JOBS Act directed the SEC to eliminate the prohibition against general solicitation in security offerings made under Rule 506 provided that all purchasers of the securities are accredited investors. Section 201(a)(2) of the JOBS Act directed the SEC to revise Rule 144A(d)(1) to provide that securities to be sold pursuant to Rule 144A may be offered through a general solicitation so long as the final purchasers are qualified institutional buyers ("QIBs").

The SEC has proposed new Rule 506(c), which would permit general solicitation in security offerings made under Rule 506 provided that: (1) the issuer takes reasonable steps to verify that purchasers are accredited investors, (2) each purchaser qualifies or the issuer reasonably believes that each purchaser qualifies as an accredited investor at the time of the sale of securities, and (3) all terms and conditions of Rule 501 and Rules 502(a) and (d) are satisfied. The SEC did not propose specific verification methods to be used by issuers, but recommended that issuers consider the following factors when determining the reasonableness of the steps taken to verify that a purchaser is an accredited investor: (a) the nature of the purchaser and type of accredited investor that the purchaser claims to be, (b) the amount and type of information that the issuer has about the purchaser, and (c) the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as the minimum investment amount. For privately offered funds, including hedge funds, venture capital funds and private equity funds, the SEC stated that conducting a general solicitation pursuant to proposed Rule 506(c) would not cause an offering to be deemed a public offering for purposes of relying on the exclusions from the definition of investment company set forth in Sections 3(c)(1) and 3(c)(7) of the 1940 Act.

Comments on the proposal are due by October 5, 2012.

SEC and CFTC Adopt Further Definitions of Swap and Related Terms

On July 18, 2012, the SEC and CFTC adopted joint rules further defining the term "swap" and other related terms as required by the Dodd-Frank Act as part of the new regulatory framework for swaps. The rules provide clarification of the types of agreements, contracts and transactions that are considered "swaps," which are regulated by the CFTC, and those that are considered "security-based swaps," which are regulated by the SEC. The rules also address "mixed swaps," which are regulated by both the SEC and CFTC, as well as "security-based swap agreements," which are

regulated by the CFTC but over which the SEC has anti-fraud authority. The rules become effective on October 12, 2012. The adoption of the rules or their effectiveness also trigger the effective or compliance dates of certain other SEC and CFTC rules that reference the final swap definitions, including amended CFTC Rule 4.5 regarding the registration and compliance obligations of commodity pool operators and commodity trading advisors.

CFTC Extends Compliance Date for CPO and CTA Registration

On July 13, 2012, the CFTC's Division of Swap Dealer and Intermediary Oversight granted no-action relief exempting certain commodity pool operators (CPOs) and commodity trading advisors (CTAs) from CFTC registration through December 31, 2012. Pursuant to the no-action letter, eligible advisers and sponsors of new registered investment companies and certain privately offered pools launched after July 13, 2012 will not be required to register as CPOs or CTAs under amended CFTC Rule 4.5 or Rule 4.13(a)(4) until December 31, 2012. In order to rely on the no-action relief, eligible advisers and sponsors must maintain compliance with the substantive provisions of the letter (which parallel the provisions of former Rules 4.5 and 4.13(a)(4)) and file a claim with the CFTC prior to engaging in business that would otherwise require registration.

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.

OTHER NEWS

PCAOB Adopts Standard on Auditor Communications with Audit Committees

On August 15, 2012 the PCAOB adopted Auditing Standard No. 16 (AS 16), *Communications with Audit Committees*, replacing and expanding the PCAOB's interim auditing standards AU sec. 380, *Communication with Audit Committees*, and AU sec. 310, *Appointment of the Independent Auditor*. AS 16 specifies the communications an auditor must make to audit committees and encourages "effective two-way communication between the auditor and the audit committee." The new standard requires, among other things:

- *Engagement.* Auditors must establish an understanding of the terms of the audit engagement with the audit committee. The terms of the engagement must be recorded in an engagement letter executed on behalf of the company with the audit committee's acknowledgement and agreement.

- *Communications.* AS 16 retains many of the communications requirements in AU sec. 380 and also incorporates new communications requirements to provide the audit committee with additional information. Pursuant to AS 16, auditors are required to communicate:

  - certain matters regarding the company's accounting policies, practices and estimates;

  - the auditor's evaluation of the quality of the company's financial reporting;

  - information related to significant unusual transactions;

  - the auditor's views regarding significant accounting or auditing matters when the auditor is aware that management consulted with other accountants about such matters and the auditor has identified a concern regarding these matters;

  - an overview of the overall audit strategy, including timing of the audit, significant risks identified by the auditor and significant changes to the planned audit strategy or identified risks;

  - information about the nature and extent of specialized skill or knowledge needed in the audit;

  - the basis for the auditor's determination that he or she can serve as principal auditor if significant parts of the audit will be performed by other auditors;

   - concerns regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective;
   - difficult or contentious matters for which the auditor consulted outside of the engagement team;
   - the auditor's evaluation of going concern;
   - departure from the auditor's standard report; and
   - other significant matters, including complaints or concerns regarding accounting or auditing matters that come to the auditor's attention during the audit.

- *Timing*. Auditors must make the required communications to the audit committee before the auditor issues its audit report.
- *Inquiries*. Auditors must make additional inquiries of the audit committee to address whether the audit committee is aware of matters relevant to the audit, including violations or possible violations of laws or regulations.

If approved by the SEC, AS 16 will be effective for audits of fiscal years beginning on or after December 15, 2012.

PCAOB Issues Guidance on Inspection Process

On August 1, 2012, the PCAOB issued guidance regarding the PCAOB's audit firm inspection process. The guidance is intended to assist audit committees in understanding the PCAOB's inspections of audit firms and in gathering information from their auditors about those inspections. The release provides an overview of the PCAOB inspection process and explains the types of findings contained in an inspection report. Part I findings are made public by the PCAOB and describe audit deficiencies where inspection staff found that the auditor failed to gather sufficient audit evidence to support an audit opinion. Part II findings describe deficiencies found in the audit firm's overall system of quality control that lead the PCAOB to doubt that the system provides reasonable assurance that professional standards are met. Part II findings may not be made public by the PCAOB unless the PCAOB determines that an audit firm failed to remediate the findings within twelve months of the issuance of the PCAOB's inspection report; however, the audit firm may voluntarily release the Part II findings contained in its inspection report.

The release identifies the following possible questions that an audit committee may wish to ask an audit firm about a PCAOB inspection:

- Was the company's audit selected for PCAOB inspection?

- Did the PCAOB identify deficiencies in other audits that involved auditing or accounting issues similar to issues presented in the company's audit?

- What were the audit firm's responses to the PCAOB findings?

    - The PCAOB cautions that in considering an audit firm's responses to inspection findings certain responses "should be viewed with skepticism." These responses include those that might minimize the significance of a PCAOB finding, such as that there was "just a documentation problem" or "a difference in professional judgment."

- What topics were included in Part II findings?

    - The PCAOB notes that audit firms may be reluctant to share the details of Part II findings, in which case an audit committee may want to ask for certain generic information about Part II findings, including (1) what changes the audit firm is making to address the findings, (2) whether the PCAOB has provided any initial indications that the audit firm's remediation efforts may not be sufficient and (3) what final determinations the PCAOB has made about the audit firm's remediation efforts.

The PCAOB release is available at:
http://pcaobus.org/Inspections/Documents/Inspection_Information_for_Audit_Committees.pdf.

ENFORCEMENT ACTIONS

SEC Charges Former Adviser to NASCAR Mutual Fund with Securities Law Violations

On August 10, 2012, the SEC charged David W. Dube and his investment advisory firm, Peak Wealth Opportunities LLC, with various violations of the federal securities laws in connection with the firm's service as investment adviser to StockCar Stocks Mutual Fund, Inc. The order initiating administrative and cease-and-desist proceedings against Mr. Dube and Peak Wealth alleged that Mr. Dube and Peak Wealth failed to: (1) provide the fund's board with information necessary for the board to evaluate the nature, quality and costs of Peak Wealth's services in connection with the board's review of the fund's advisory agreement; (2) file annual amended Forms ADV and make, keep and furnish true, accurate and current books and records for Peak Wealth's advisory business, including financial statements, bank records, trial balances and income and expense statements; and (3) withdraw its SEC registration as a registered investment adviser following the board's termination of Peak Wealth's advisory contract with the fund, which was the firm's sole client. The SEC's order stated that, despite repeated requests from the board in March and May 2010, Peak Wealth failed to provide the board with any requested documents for purposes of the board's review of the advisory agreement. As a result, in June 2010, the board terminated Peak Wealth's advisory agreement with the fund and voted to liquidate and deregister the fund. The SEC's order also stated that

Peak Wealth failed to produce financial records in response to eight different requests for financial records from SEC examination staff during an examination of Peak Wealth and the fund in 2010. Finally, according to the SEC's order, Peak Wealth neither filed a Form ADV-W (after it became ineligible for SEC registration following the termination of the advisory agreement with the fund) nor annually amended Form ADV for its fiscal years ended September 30, 2009, 2010 and 2011.

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.

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