Chapter 6

Mutual Funds

Clifford E. Kirsch
Partner, Sutherland

Bibb L. Strench
Counsel, Seward & Kissel LLP

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§ 6:1  A Brief History of the Mutual Fund Industry

An investment company is a vehicle that pools investor money for the purpose of investing in securities. The most popular type of investment company is the open-end management company, typically called the mutual fund. Other types of investment companies are closed-end funds, exchange-traded funds, business development companies and unit investment trusts. These are all public funds because their shares are publicly sold to investors and thus the funds and their shares are required to be registered with the SEC. Investment companies that privately offer and sell their unregistered shares to investors are called private or hedge funds. The recently enacted Jumpstart Our Business Startup Act (the “JOBS Act”) eliminated the prohibition against general solicitation and general advertising in connection with private offerings to accredited investors conducted in reliance on Rule 506 of Regulation D promulgated under the Securities Act of 1933 (the “Securities Act”). The SEC is currently proposing rules to implement this law.

Today, mutual funds are an integral part of financial activity in American life. A mind-boggling one-third of the families in the United States invest in mutual funds. From 1980 through 2008, the total net assets invested in mutual funds grew from $134 billion to over
$13 trillion, while the number of U.S. households owning mutual funds grew from 4.6 million to 52.3 million.¹ Thousands of mutual funds with countless strategies and objectives stand ready to serve these households. The fund industry traveled a long road in reaching this prominence in the financial services world.

The first type of investment company was the unit trust, which was a fixed pool of securities that, unlike a mutual fund, was not actively managed. The first unit trust was formed in England in 1868. In 1924, a unit investment trust formed as a Massachusetts trust appeared in the United States. At around this time, actively managed open-end and closed-end funds became popular. In contrast to the unit investment trusts, these funds were highly leveraged and speculative, and their value plummeted during the great stock market crash of 1929.

The “safer” unit investment trusts regained popularity after the market crash and were the dominant form of investment company until their returns lagged during the Great Depression. In the 1930s, investors sought professional management and gravitated toward open-end and closed-end funds, which gave their portfolio managers the power to change the underlying portfolio of securities.

During these years, closed-end investment companies were another popular type of fund.² An important feature of these closed-end companies was their use of leverage. Closed-end companies employed leverage by issuing bonds and preferred stock. This permitted the company to access capital that was used to purchase portfolio securities.

Prompted by the investor losses during the 1929 market crash, Congress initiated an SEC study and report on “the functions and activities of investment trusts and investment companies.”³ In doing so, Congress recognized that investment companies were generally subject only to disclosure regulation under the Securities Act, thereby escaping regulation of the type that was applied to other financial intermediaries such as banks and insurance companies. Congress believed that a specialized body of regulation was needed because: (1) the organizational structure of the investment company resulted in potential conflicts of interest, and (2) the portable nature of investment company assets afforded the opportunity for exploitation on the part of persons, such as the investment adviser, who had an important relationship with the investment company.

2. The major difference between a closed-end fund and an open-end fund is that the sponsor of an open-end fund stands ready to redeem shares while the sponsor of a closed-end fund does not. Closed-end fund shareholders may only sell their shares to other investors on an exchange.
The report produced by the SEC in the late 1930s found widespread abuse in the investment company industry. Among the abuses reported by the SEC was outright theft. The report also found a variety of types of self-dealing transactions. The study concluded that many investors were moved from fund to fund, for no reason other than to allow sponsors and salespersons to “earn” additional brokerage commissions.

In dealing with these abuses, Congress had a variety of options. One option was simply to enhance the disclosure scheme of the Securities Act of 1933 to make sure that investors were made aware of the potential abuses. Another option was to impose a licensing and approval process on individuals connected with funds. A third option was to regulate the operations of funds. The Investment Company Act of 1940 (the “Investment Company Act”) as enacted generally reflects this last option.4

The enactment of the legislation, fully supported by the industry, helped restore investor confidence. As a result, the decline of the industry was reversed and assets in investment companies began to grow in the 1940s and 1950s.

In the 1960s, the first mutual fund scandal since the enactment of the Investment Company Act in 1940 occurred. Bernie Cornfeld formed Investors Overseas Services [IOS], which was incorporated in Geneva, Switzerland. In 1962, IOS launched Fund of Funds, Ltd., an unregistered fund that quickly established controlling interests in several registered and notable U.S. funds. Fund of Funds, Ltd. engaged in many abusive activities that were similar to the abuses that led to the enactment of the Investment Company Act. These included charging duplicative advisory fees at the acquiring and acquired fund levels, providing sales loads to an affiliated broker for each investment the acquiring fund made in an acquired fund, and directing the U.S. funds to send brokerage business to an affiliate of Fund of Funds, Ltd. (which then rebated a portion of the commission to IOS). In addition, Fund of Funds, Ltd. through its large holdings exerted undue influence on the management of acquired U.S. funds by threatening advisers to those funds with large redemptions.

Around the same time, the SEC requested that the Wharton School of Finance and Commerce study the mutual fund industry. The result was two reports: “A Study of Mutual Funds”5 and the “Report of the Special Study of Securities Markets of the Securities and Exchange Commission.”6 In 1966, the SEC, drawing upon the Wharton reports, issued the “Report of the Securities and Exchange Commission on the

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Public Policy Implications of Investment Company Growth” ("PPI Report"). The SEC in the PPI Report recommended a number of reforms, including that Congress amend the Investment Company Act to require that any compensation received for services provided by investment advisers be “reasonable” and impose a statutory cap of 5% on sales loads for mutual funds. The SEC, in response to the IOS scandal, also recommended that Congress revisit section 12(d)(1) of the Investment Company Act, which governs investments by investment companies in other investment companies.

In response, Congress in 1970 amended the Investment Company Act provisions regarding advisory fees and sales charges. Congress added section 36(b) to the Investment Company Act to impose a fiduciary duty on the investment adviser of a fund with respect to the receipt of compensation for services. Congress also amended section 15(c) of the Investment Company Act to impose on directors a duty to evaluate, and on an adviser a duty to furnish, all relevant information needed to review the terms of an advisory contract. In 1970, rather than impose a cap on sales loads as the SEC recommended, Congress decided that industry regulation was the preferable approach. Section 22(b) of the Investment Company Act was revised to provide the National Association of Securities Dealers, Inc. (NASD) (now called the Financial Industry Regulatory Authority (FINRA)) authority to restrict sales loads subject to SEC oversight. Subsequently, the NASD promulgated a rule prohibiting NASD members from selling mutual fund shares if the sales charges exceed specified caps. Congress also amended section 12(d)(1) of the Investment Company Act to tighten the restrictions on funds of funds and extended them to unregistered funds that invest in registered funds.

The introduction of the money market fund in the 1970s had a profound impact on the financial services industry. First, many money market funds were offered directly to investors without a broker. This ushered in a new generation of investors who were comfortable fending for themselves financially without a broker. Second, as funds began to offer more services in connection with their money market fund accounts (check writing), some people began to view money market fund accounts as an alternative to checking accounts.

In 1978, the SEC granted an exemptive order to Vanguard permitting it to use fund assets to pay for distribution pursuant to a “Rule 12b-1 plan.” This made it economically feasible for sponsors to offer mutual funds directly (that is, not through broker-dealers) and without a sales load (that is, a percentage of the initial fund investment

paid to the broker-dealers). Money began pouring into these so-called “no-load funds.” Similar to the 1960s, the mutual fund industry in the 1980s produced superstar portfolio managers, with Fidelity’s Peter Lynch and others becoming household names.

The late 1980s to early 1990s was a period of further innovation in the mutual fund industry. The first fund of affiliated funds appeared. Funds also began offering multiple classes of shares. In 1993, State Street Bank launched the first exchange-traded trust, called the S&P Depositary Receipts Fund or SPDR. The tremendous inflow of money continued into the 1990s. The 1990s also saw new channels for distributing mutual fund shares. Whereas mutual funds used to be sold only by brokerage firms or by the funds directly, in recent years increasing sales have taken place through banks, 401(k) pension plans, and independent financial planners. According to the Investment Company Institute, 86% of the households who own mutual fund shares hold such shares through intermediaries and not directly.9

A number of events outside the mutual fund industry from 1999 through 2002 nevertheless resulted in additional regulation of mutual funds. In 1999, Congress enacted the Financial Modernization Act, also known as the Gramm-Leach-Bliley Act.10 This new law and Regulation S-P, the rule the SEC adopted to implement its provisions, required mutual funds to create privacy policies and notices, and adopt procedures to safeguard shareholder information.11

In response to the terrorist attacks on September 11, 2001, Congress enacted the Uniting and Strengthening America by Providing Appropriate Tools to Restrict, Intercept and Obstruct Terrorism Act, also called the USA PATRIOT Act or Patriot Act.12 This led to the adoption by the SEC and banking agencies of anti-money laundering rules that apply to a variety of financial institutions, including mutual funds.

Accounting scandals by non–mutual fund public issuers of securities, most notably Enron and WorldCom, led to the enactment

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11. In 2009, the SEC adopted Regulation S-AM, which addresses affiliate marketing through the use of consumer information. See Investment Company Act Release No. 28,842 [Aug. 4, 2009]. Regulation S-AM is designed to prevent registered investment advisers, investment companies, broker-dealers, and registered transfer agents (covered persons) from using certain consumer information provided by a covered persons affiliate to market products or services, unless there is full disclosure to the consumer and the consumer does not “opt out” of such marketing. Id.
of the Sarbanes-Oxley Act of 2002.\textsuperscript{13} Congress elected to apply this law to the mutual fund industry. Sarbanes-Oxley includes provisions enhancing the independence of auditors, requiring disclosure controls and procedures, and requiring that mutual funds have financial codes of ethics.

The years 2003–2004 saw the second mutual fund scandal since the enactment of the Investment Company Act. Allegations of improper trading activity, undisclosed compensation arrangements with brokerage firms related to fund distribution, high fees and expenses, and improper sales practices were propelled to the news headlines. The SEC responded with sweeping regulatory reforms in these and other areas.

The economic events of 2008–2009 have significantly impacted the financial services industry, including mutual funds. Most notably, the first large retail money market fund “broke a dollar.” The $62 billion Reserve Fund, on September 18, 2008, announced that the shares of its Primary Fund had a net asset value of $0.97. As a result of Lehman Brothers Holdings Inc.’s bankruptcy, a dollar was broken because the Reserve Fund had to value approximately $785 million of its Lehman Brothers debt securities at zero.

After the Reserve Fund incident, the U.S. Treasury Department took action to shore up the money market fund industry, largely because of its vital importance to the overall financial system. On September 29, 2008, Treasury established the Temporary Guarantee Program for Money Market Funds. This “insurance-type” program made available $50 billion to participating money market funds if they were to experience an event causing them to break a dollar. Other federal actions directed at shoring up U.S. money market funds were the Asset Backed Commercial Paper Money Market Fund Liquidity Facility, the Money Market Investor Funding Facility, and several no-action letters adding flexibility to Rule 2a-7 under the Investment Company Act, which regulates money market funds. These programs have generally expired.\textsuperscript{14}

On January 27, 2010, the SEC significantly amended Rule 2a-7 under the Investment Company Act—the rule that regulates money market funds—in response to the Reserve Fund incident. The amendments added significant restrictions in an attempt to make it less likely that a money market fund will collapse in the future. Among other changes, the restrictions on what constitutes an eligible money market fund portfolio security were tightened, money market funds

\begin{itemize}
\item \textsuperscript{14} Press Release, U.S. Dep’t of Treasury, Treasury Announces Expiration of Guarantee Program for Money Market Funds (Sept. 18, 2009), \textit{available at} www.ustreas.gov/press/releases/tg293.htm.
\end{itemize}
must now maintain a dollar-weighted average portfolio life of 120 days or less, monthly disclosure of all portfolio holdings must be posted on the fund’s website, and funds must make monthly filings of portfolio holdings and certain other information with the SEC. In early 2012, the SEC announced that it was considering further action regarding the regulation of money market funds. Possible proposals included a 1% capital buffer requirement, the imposition of a thirty-day hold-back on redemption requests by investors, and a floating net asset value.

Another fund product adversely impacted by the 2008–2009 financial crisis was the auction rate preferred security. These securities were issued by a variety of closed-end funds sponsored by major financial institutions that made markets in the securities. Because of the adverse market events, the auction rate preferred securities markets froze, making it impossible for many investors to sell the auction rate preferred securities they held. As a result of pressure and in some cases enforcement by the SEC and other securities regulators, certain sponsors have voluntarily stepped in to purchase auction rate preferred securities from investors. However, many investors are still unable to sell their auction rate preferred securities holdings.

In July 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)\(^\text{15}\) in response to the market and overall economic credit crisis. The Dodd-Frank Act is the most significant legislative change in the regulation and supervision of financial institutions since the Great Depression.

The Dodd-Frank Act contains several provisions, rulemaking directives, and required studies that will impact investment companies and their advisers. With the exception of money market funds, investment companies and their advisers were largely unaffected by the crisis and therefore not the focus of the Dodd-Frank Act. Title IX of the Dodd-Frank Act requires the SEC to adopt a panoply of rules, including rules requiring disclosure of the compensation of certain employees and how funds votes on compensation items in proxies (“Say on Pay”), as well as “whistleblowing” rules that pay bounties to employees who provide information to the SEC that leads to penalties of $1 million or more. In addition, the Dodd-Frank Act requires the SEC to conduct a number of studies, including a study on SEC examinations and harmonizing investment adviser and broker-dealer regulation. New regulatory schemes for swaps and other derivatives called for by the Dodd-Frank Act also will indirectly impact mutual funds that invest in such instruments.

The Dodd-Frank Act also created the Financial Stability Oversight Council (FSOC) and Office of Financial Research. On April 3, 2013, the

\(^{15}\) Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (July 21, 2010).
Federal Reserve Board issued a final rule that establishes the requirements for determining when a company is “predominantly engaged in financial activities.” The requirements will be used by the FSOC when it considers the potential designation of a nonbank financial company, which may include a mutual fund, as a significantly important financial institution (SIFI).

To determine which nonbanks, such as mutual funds, are SIFIs, if any, the FSOC developed an analytical framework based on a quantitative screening process, followed by a qualitative and quantitative assessment. Based on data generated by these processes, it then performs an in-depth analysis that examines factors that help predict the magnitude of the impact on the broader economy of the failure of a particular nonbank, such as a mutual fund, and factors that indicate how likely that nonbank is to fail. Once a determination is made, the nonbank has the opportunity to respond and request a review hearing prior to a final determination of SIFI status.

It remains to be seen whether mutual funds, particularly money market funds, will come within this governing body’s regulatory scheme, which is charged with overseeing financial institutions that present the possibility of causing significant systemic risks to the nation’s financial system.

Despite the market crisis, the SEC was able to significantly advance mutual fund disclosure reform. Amendments to Form N-1A were adopted on January 13, 2009, that allow mutual funds to deliver a short-form prospectus and have other information about the mutual fund posted on the fund’s website. The summary prospectus, several pages in length, contains key information about the mutual fund, and its delivery will be deemed to satisfy the prospectus delivery requirements of the Securities Act. By making available additional information on its website, the fund is deemed to have also delivered the additional information under the theory that investors can access this information through the Internet. This “access equals delivery” regulatory model is a major breakthrough in the SEC’s application of the securities laws, and helps align the mutual fund industry with similar disclosure breakthroughs in the securities regulations that govern ordinary corporate issuers of securities.

In 2008, a circuit court decided to not follow the traditional standards followed by mutual fund directors to annually review investment advisory contracts, causing a split in the circuit courts regarding how directors should review such contracts. On March 30,

17. See Jones v. Harris Assocs., 527 F.3d 627 [7th Cir. 2008].
2010, the U.S. Supreme Court in *Jones v. Harris*\(^{18}\) unanimously upheld the principles for determining the reasonableness of mutual fund fees established by the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*\(^{19}\)

The SEC proposed a new rule and rule amendments that would replace Rule 12b-1 under the Investment Company.\(^ {20}\) The proposal would limit the amount of asset-based sales charges that individual investors pay by restricting “ongoing sales charges” to the highest fee charged by the investment company for shares that have no ongoing sales charge. The investment company would have to keep track of how long investors have been paying ongoing sales charges. Separately, investment companies could continue to pay .25% per year out of their assets for distribution as “marketing and service” fees for expenses such as advertising, sales compensation, and services. The rules would also enhance disclosure requirements. The SEC has not adopted these amendments and likely would re-propose them before doing so.

After conducting a review of the use of derivatives by mutual funds, the SEC’s Division of Investment Management in 2011 issued a concept release where it stated its desire to establish a new framework to regulate this practice and address a wide variety of issues relevant to funds’ use of derivatives.\(^ {21}\) The concept release addressed and solicited comment on the costs, benefits, and risks of fund use of derivatives, including ETF derivative practices; the application to derivatives of the Investment Company Act’s restrictions on leverage and portfolio diversification and concentration requirements; considerations relating to investment in securities-related issuers and to counterparty exposure; and valuation issues. The SEC has not yet proposed any rules or other actions regarding mutual fund derivative practices.

On February 9, 2012, the Commodity Futures Trading Commission (CFTC) amended CFTC Rule 4.5, which is the exclusion from the definition of commodity pool operator (CPO) that mutual funds have relied on to avoid the need for CPO registration. Amended Rule 4.5 imposes significant new conditions on claiming the exclusion. These changes have resulted in the need for CPO registration in situations where a mutual fund’s investment program has a significant commodities component or a mutual fund makes more than


\(^{19}\) Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982).


limited use of commodities and swaps for other than bona fide hedging purposes.

§ 6:2  The Players

Unlike typical business enterprises, mutual funds do not operate on their own or employ a full-time staff. Rather, they contract out with investment advisers, underwriters, and others to provide needed services. These providers often are companies that are affiliated with one another and which conceive the fund and bring it to life.

The following summarizes the various players involved in the operation of a typical mutual fund and the role that each plays.

§ 6:2.1 Mutual Funds

Mutual funds are separate legal entities most often formed as a business trust or corporation. Although funds are organized under the laws of a number of states, most registered funds organized in corporate form are organized as Maryland corporations, and most funds organized as business trusts are organized as Massachusetts business trusts or Delaware statutory trusts.

Largely because of the Investment Company Act, each mutual fund structurally resembles that of the typical corporation. It is a separate legal entity with a board of directors, officers and shareholders. The major responsibility of the board is to guard against adviser abuse. Like corporations, the liability of shareholders is generally limited to their investment.

Although a fund resembles a typical corporation, there are significant differences. First, typical corporations are staffed by employees. In contrast, a mutual fund generally has no employees. Rather, a mutual fund contracts with third parties for all of the services it needs. For example, a mutual fund typically does not have advisory services provided by its staff. Instead, such services are typically provided pursuant to a contract that the fund enters into with the adviser. The adviser is required to be registered under the Investment Advisers Act of 1940 (the “Investment Advisers Act”). Because of this, practitioners in this area must master both the Investment Company Act and the Investment Advisers Act.

Mutual funds are structured differently than corporations. Multiple portfolios or series of shares within a single legal entity are often referred to as a “series fund.” In a series fund, each series may have different investment objectives, policies and potential investors, and each series represents a segregated portfolio of the series fund’s assets.

Some mutual funds have a two-tiered or master-feeder structure. The master fund is a registered investment company. The feeder funds are also registered and hold a single investment: shares in the master fund. The master and the feeder funds have the same investment objectives.
and policies. The feeder funds are typically distinguished from one another by their targeted market and distribution arrangements.

Amendments to the Investment Company Act in 1996 permitted flexibility with respect to a similar type of structure, referred to as a fund of funds. In this arrangement, a registered investment company invests in other investment companies. The 1996 amendments allowed for fund of funds within the same fund family.

Many funds have a multi-class structure. In the multi-class structure, a registered investment company issues separate classes of shares, typically with separate distribution arrangements. The “Class A” shares typically have a front-end sales load; the “Class B” a contingent deferred sales load; and the “Class C” a level-load structure.

§ 6:2.2 Investment Adviser

The investment adviser is typically the third party that organizes and promotes the fund from its inception. It puts in place all of the necessary service arrangements, such as the distribution agreement, the shareholder servicing agreement, and the transfer agency servicing agreement.

The adviser’s main role is to supervise and manage the fund’s assets, including handling the fund’s portfolio transactions. In most mutual funds, management is contracted out to an external investment adviser. In these cases, the portfolio manager, analysts, and other professional staff assigned to a fund are employees of the adviser, not the fund. For its work, an adviser is paid an advisory fee which is typically computed as a fee against the fund’s net assets (for example, 0.75% of net assets).

The investment adviser is responsible for a fund’s portfolio management. The investment adviser selects someone from its staff to serve as the fund’s portfolio manager. Alternatively, the fund may select several of its staff to run the fund. This is known in the industry as advising by committee.

Other players are involved in a fund’s portfolio management activity. In larger fund complexes, a group of individuals called a “trading desk” selects broker-dealers and enters trades recommended by the portfolio managers.

A variation on the traditional portfolio management structure is the manager of managers structure. Here, an adviser supervises one or more sub-advisers. The adviser is responsible for hiring, supervising, and (if determined to be necessary) discharging the sub-advisers. The sub-advisers are responsible for all or a portion of the day-to-day management of the fund’s portfolio.

§ 6:2.3 Board of Directors

The Investment Company Act requires mutual funds to have a board of directors. The function of the board, and, in particular, the
disinterested directors, is to protect shareholders against the possibility of overreaching by those who are affiliated with the investment company. The U.S. Supreme Court has called independent directors the “watch-dogs” of the mutual fund industry, vested with safeguarding the interests of the fund’s shareholders, particularly in conflict-of-interest situations.\textsuperscript{22} Consistent with this, several provisions of the Investment Company Act require that matters crucial to the independent functioning of the mutual fund be approved not only by a majority of the board of directors, but separately by a majority of the disinterested directors. The act requires that at least 40\% of the board members must be disinterested; the others may be interested. Practically speaking, most mutual funds have a greater percentage of independent directors than required by the statute. Typically, an interested director is also an officer, director, stockholder or principal of the fund’s investment adviser or underwriter. A disinterested director generally has no material relationship with the investment adviser or underwriter or their affiliates. As we will see, the primary purpose of the board is to check self-interested management. While the board may delegate certain oversight responsibilities to the investment adviser, the directors themselves retain overall responsibility for proper operation of the fund.

\textbf{§ 6:2.4 Administrator}

The administrator provides, among other things, the executive, administrative, clerical personnel, office facilities and supplies to enable the mutual fund to conduct its business. The administrator provides accounting services to the fund and may be responsible for determining its daily price. In many cases, the investment adviser performs the functions of the fund’s administrator; in other cases, the administrator is a separate, affiliated or unaffiliated company.

\textbf{§ 6:2.5 Underwriter or Distributor}

Except when a fund acts as its own underwriter, the shares of a registered investment company are sold to the public through an underwriter, also called the distributor. The underwriter is a broker-dealer registered with the SEC under the Securities Exchange Act of 1934 (the “Exchange Act”), and is generally a member of FINRA (formerly NASD). The underwriter may be the sponsor of the fund or an affiliate of the sponsor.

The fund’s principal underwriter purchases shares directly from the fund and sells them to the public either directly or indirectly through other broker-dealers or other financial institutions.

\textsuperscript{22.} Burks v. Lasker, 441 U.S. 471, 484 (1979).
§ 6:2.6 Custodian

A primary focus of the Investment Company Act is to ensure that the assets of the mutual fund are maintained in a secure arrangement and are not misappropriated by persons with access to the assets. The Investment Company Act requires that a mutual fund hold fund assets, including cash and securities, in safe custody. Typically, a bank serves as custodian. However, the Investment Company Act also allows for self-custody by the fund and for custody by a broker-dealer if certain conditions are met.

§ 6:2.7 Transfer Agent

A mutual fund appoints a transfer agent to keep records of shares issued and redeemed. The transfer agent frequently doubles as the fund’s dividend disbursing agent, either mailing distribution checks to shareholders or issuing additional shares if shareholders elect to reinvest their dividends in the fund.

§ 6:2.8 Independent Auditors

Every mutual fund must appoint independent certified public accountants to report to the shareholders, at least annually, on the fund’s financial condition. These reports, which must be filed with the SEC, include a statement of assets and liabilities, a schedule of investments, a statement of operations, a statement of changes in net assets, and a schedule of selected data per share.

§ 6:2.9 Legal Counsel

Fund counsel advises the fund and its directors on a broad range of matters. In addition to reviewing registration statements and other regulatory filings, fund counsel also passes upon the legality of the securities being issued by the fund.

Because independent directors often seek the advice of their own counsel, especially in situations presenting a potential conflict between the fund and its investment adviser, independent directors often have their own counsel. Counsel advises the board on its responsibilities and helps to ensure that it receives the information it needs to fulfill its fiduciary obligations. In some cases, the adviser has its own counsel for mutual fund–related matters.

§ 6:2.10 Chief Compliance Officer

In 2003, the SEC adopted Rule 38a-1 under the Investment Company Act, requires mutual funds to designate an individual as chief compliance officer to be responsible for administering the fund’s compliance policies and procedures. The SEC has stated that the chief compliance officer must have sufficient seniority and authority in the organization.
to compel others to adhere to the fund’s policies and procedures. The rule includes certain provisions requiring the chief compliance officer to operate somewhat independently of fund management. In this connection, the chief compliance officer must provide an annual written report to the board and must meet separately with the independent directors at least annually. Besides being an officer of the mutual fund, the chief compliance officer is often an employee of the adviser and, in some cases, an employee of a company not affiliated with the fund or adviser.

§ 6:2.11 Shareholders

Fundamental to the Investment Company Act is the principle that a registered fund is owned by its shareholders—not its sponsor, investment adviser or distributor—and that governance of the fund must therefore be the ultimate responsibility of independent individuals acting on behalf of the shareholders and not on behalf of the sponsor or its affiliates.

§ 6:3 Organizational Structure

§ 6:3.1 The Mutual Fund Complex

Having discussed the role of the different players, we now look at a fund’s organizational structure.
As a starting point, we take a bird’s-eye view of the mutual fund complex in the illustration above. Whereas, in the early years of the industry, sponsors limited themselves to operating one or two funds, today sponsors create large “fund families” made up of numerous funds. Under the Investment Company Act, the fund complex as a whole is not registered; rather, each fund is separately registered.

§ 6:3.2 The Adviser and the Board

Figure 6-2
As illustrated in the top half of the diagram above, each mutual fund structurally resembles that of the typical corporation. It has a board of directors and it is authorized to do business under state law either as a corporation or a trust. The major responsibility of the board is to guard against adviser abuse. As illustrated in the bottom half of the diagram, a mutual fund departs from the typical corporate model because it outsources its operations to a third-party investment adviser.

\[ \text{§ 6:3.3 The Fund's Distribution Structure} \]

The shares of a mutual fund are sold to the public through an underwriter (also called the distributor), except in the rare case when a fund acts as its own distributor.\(^\text{23}\)

One very popular way of structuring fund distribution is where a fund enters into a distribution agreement with a principal underwriter that in turn enters into agreements with a broker-dealer(s) who sells to the public. This method of distribution is illustrated as follows:

**Figure 6-3**

![Figure 6-3]

Another popular arrangement is where a fund enters into a distribution agreement with a principal underwriter who sells directly to investors. This is illustrated as follows:

**Figure 6-4**

![Figure 6-4]

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23. As noted, the principal underwriter is usually the sponsor or an affiliate of the sponsor.

(Fin. Prod. Fund., Rel. #3, 7/14) 6–17
Another variation is where a fund operates without a separate principal underwriter and enters into selling arrangements directly with broker-dealers. This arrangement is infrequently used because most fund complexes employ a principal underwriter in order to insulate liability with respect to the marketing and distribution of fund shares.

**Figure 6-5**

![Diagram showing direct selling arrangements with broker-dealers](image)

**§ 6:3.4 Portfolio Management Structure**

**Figure 6-6**

![Diagram illustrating portfolio management structure](image)

As illustrated above, a fund’s portfolio management is the responsibility of the investment adviser. The investment adviser selects someone from its staff to serve as the fund’s portfolio manager. Alternatively, the fund may select several of its staff to run the fund. This is known in the industry as advising by committee.

Other players are involved in a fund’s portfolio management activity. For each trade that a fund enters into, a brokerage firm needs to be selected to execute the trade. Also, a custodian (typically, a bank)
is required by the Investment Company Act to be selected in order to
safe-keep assets.

A variation on the traditional portfolio management structure is the
manager of managers structure, which is illustrated below. Here, an
adviser supervises one or more sub-advisers. The adviser is respon-
sible for hiring, supervising, and (if determined to be necessary)
discharging the sub-advisers. The sub-advisers are responsible for all
or a portion of the day-to-day management of the fund’s portfolio.

Figure 6-7

§ 6:3.5 Marketing Structures

Historically, mutual funds were structured either as a stand-alone
entity or as part of series fund (that is, a separate fund that is part of a
larger entity that includes one or more other separate funds) and distrib-
uted as such. While these structures are still used, during the past decade
new marketing models began to emerge that today are very popular.

The first such model that we discuss is the master-feeder arrange-
ment, illustrated as follows:

Figure 6-8
The structure involves a two-tiered investment vehicle. The master fund is a registered investment company. The feeder funds are also registered and hold a single investment, shares in the master fund.

The master and the feeder funds have the same investment objectives and policies. The feeder funds are typically distinguished from one another by their targeted market and distribution arrangements.

In the multi-class structure, a registered investment company issues separate classes of shares, typically with separate distribution arrangements. One popular type of multi-class structure is that sold by brokerage firms. The "Class A" shares typically have a front-end sales load, the "Class B" a contingent deferred sales load, and the "Class C" a level-load structure.

Figure 6-9

Amendments to the Investment Company Act in 1996 permitted flexibility with respect to another type of structure, referred to as a fund of funds. In this arrangement, which is illustrated below, a registered investment company invests in affiliated investment companies. The 1996 amendments allowed for fund of funds within the same fund family.

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24. Section 12(d)(1)(F) permits a registered investment company to invest all of its assets in unaffiliated investment companies if certain conditions are met.
§ 6:4 Regulatory Framework

§ 6:4.1 Overview of the Investment Company Act

A mutual fund is one of the most regulated types of companies in the United States. This is because mutual fund assets are liquid and portable. One primary focus of the Investment Company Act is to keep the fund’s adviser in check. Provisions which serve to do this include:

1. prospectus disclosure of significant features of the investment, such as investment objectives and investment policies;
2. controls over the nature of the investment advisory contract;
3. the imposition of a board of directors to serve as a supervisory body over the adviser;
4. an express private right of action for shareholders;
5. restrictions on transactions between the fund and the adviser;
6. restrictions on investments; and
7. requiring fund assets to be held at a bank and not by the adviser.

In addition to the set of provisions which regulate advisory services and fees, other requirements of the Investment Company Act focus directly on a fund’s capital structure. These provisions include restrictions on debt, issuance of redeemable shares, and pricing of shares.

Another set of provisions regulate how fund shares are sold. These provisions include restrictions on sales loads, financing distribution...
through fund assets, and restrictions on advertising. Each of these provisions is discussed below.

§ 6:4.2 Restrictions on Advisory Services

[A] Prospectus Disclosure

The Investment Company Act requires investment companies to register pursuant to section 8 of the act. This registration is required in addition to registration under the Securities Act of the securities that an investment company publicly offers. Mutual funds register on Form N-1A. This form serves a dual purpose by allowing a fund to register itself under the Investment Company Act and its securities under the Securities Act. Form N-1A creates a two-part disclosure document. One document, the prospectus, which investors must receive; the other document, a statement of additional information, which investors receive upon request. In addition, mutual funds are permitted to use a summary prospectus, a document that briefly addresses the fund’s: (1) investment objectives; (2) costs; (3) principal investment strategies, risks, and performance; (4) investment advisers and portfolio managers; (5) brief purchase and sale and tax information; and (6) financial intermediary compensation. This document is filed separately from Form N-1A; however, the content of the summary prospectus appears in the front part of the prospectus housed in Form N-1A. Section 8(b) of the Investment Company Act and Form N-1A require mutual funds to disclose in their registration statements certain enumerated policies and investment techniques they may use as well as other investment policies the mutual fund deems fundamental. The investment objective of the fund is, in effect, its major goal (for example, aggressive growth). The investment policies are the ways in which the fund intends to achieve its objective. Disclosure is also required concerning those policies that are changeable only by shareholder vote. These provisions serve to limit the discretion that an adviser has to unilaterally alter a fund’s investment objective.

Because mutual funds typically sell their securities on a continuous basis, a current prospectus must be maintained. Specifically, section 10(a)(3) of the Securities Act requires that any prospectus used more than nine months after the registration statement’s effective date must contain financial and other information as of a date not more than sixteen months prior to such use. In addition, Rule 8b-16 under the Investment Companies Act requires a mutual fund to amend its registration statement within 120 days of its fiscal year-end. A fund updates its prospectus by filing a post-effective amendment to its registration statement that contains updated financial
statements and other information. Immaterial changes are updated via a “sticker”—a less formal process.

[B] Controls Over the Advisory Contract

Section 15 of the Investment Company Act places controls on the advisory contract. Specifically, the advisory contract must be written; precisely describe all compensation; continue for more than two years after execution only if the contract’s continuance is approved annually by the majority of the board of directors or by a majority vote of shareholders; provide that the fund’s board or shareholders may terminate it at any time without penalty on sixty days’ written notice; and provide for the contract’s automatic termination if it is assigned. 25

[C] Corporate Structure

Various provisions of the Investment Company Act establish a corporate structure to police conflicts between the fund and its adviser. Section 10 of the Investment Company Act requires that, generally, no more than 60% of the board of directors of an investment company may be composed of directors who are “interested persons” of the investment company. 26 Practically, independent directors typically constitute a majority of a fund’s board. Such constitution is a requirement for taking advantage of widely relied-upon Investment Company Act rules.

The function of the board, and, in particular, the disinterested directors, is to protect against the possibility of overreaching by those who are affiliated with the investment company. Consistent with this, several provisions of the Investment Company Act require that matters crucial to the independent functioning of the investment company be approved not only by a majority of the board of directors, but separately by a majority of the disinterested directors.

25. Investment Company Act § 15(f) permits the assignment of the advisory contract subject to two conditions. First, the assignment must be approved by a board consisting of 75% of independent directors. Second, for two years after the assignment, the investment company cannot suffer undue burden.

26. The term “interested person,” defined in section 2(a)(19) of the Investment Company Act, is quite broad. It includes not only those persons with such close financial or control relationships with the investment company that they are deemed “affiliated” with it under section 2(a)(3), but also members of affiliates’ immediate families, interested persons of the investment company’s adviser or principal underwriter, legal counsel to the investment company and his or her partners or employees, any broker or dealer registered under the Exchange Act and its affiliated persons, and others whom the SEC determines to have had, within the last two fiscal years, “a material business or professional relationship” with the investment company, its principal executive officers, or any other investment company with the same investment adviser or underwriter.
An important function of the board is to approve the advisory arrangement.

Pursuant to section 15 of the Investment Company Act, in evaluating the terms of the advisory contract, directors are required to request and evaluate, and the adviser is required to furnish, certain information. This includes information about investment performance, compensation, brokerage and portfolio transactions, and overall fund expenses and expense ratios.

Another important responsibility is to establish procedures for valuation of the fund’s holdings. Directors are also called upon to approve underwriting contracts and custody arrangements. The SEC has taken a special interest in the role of directors, urging them to take their responsibilities seriously and not make their supervision of the adviser perfunctory.

[D] Private Right of Action

The Investment Company Act imposes a fiduciary duty on the investment adviser with respect to the amount of compensation the adviser receives from the mutual fund and its shareholders.\(^\text{27}\) The SEC and shareholders are authorized to bring an action for breach of this duty against the adviser with respect to such compensation.\(^\text{28}\)

[E] Affiliated Transactions

The Investment Company Act regulates four broad categories of affiliated transactions to protect investors from a variety of conflicts of interest that may arise when assets are in the reach of affiliated parties. As relevant here:

1. section 17(a) prohibits transactions between a fund and an affiliate (for example, the adviser) or an affiliate of an affiliate acting as principal;

2. section 17(d), together with Rule 17d-1, restricts joint transactions involving a fund and an affiliate or an affiliate of an affiliate;

3. section 17(e) restricts the amount of compensation an affiliate or an affiliate of an affiliate may receive when acting as an agent to the fund;\(^\text{29}\) and

\(^{27}\) Investment Company Act § 36(b).

\(^{28}\) See, e.g., Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404 (2d Cir. 1989).

\(^{29}\) Affiliated brokerage is specifically dealt with in Investment Company Act § 17(e)(2), which imposes limitations on the amount an affiliated broker may charge a fund.
section 10(f) restricts a mutual fund’s acquisition of securities from an underwriting syndicate if a member of the syndicate is affiliated with the fund in certain ways.

The Investment Company Act provides the SEC flexibility in granting approval for certain transactions that otherwise would be prohibited by these provisions.

[F] Restrictions on Investments

Generally, the Investment Company Act is not heavy-handed with respect to the securities in which a mutual fund may invest. With the few restrictions in section 12, the act simply requires disclosure of investment policy that will be followed and limits changes in investment policies. Section 12 limits investment in broker-dealers, underwriters and advisers and other investment companies.

Other investment restrictions are imposed with respect to liquidity and diversification. It is generally accepted that mutual funds (other than money market funds) are required to hold no more than 15% of their assets in illiquid investments. “Liquidity” is not a defined term under the Investment Company Act.

The Investment Company Act categorizes mutual funds as “diversified” and “nondiversified.” Pursuant to section 5(b)(1) of the act, a mutual fund calling itself “diversified” must invest a certain amount of its assets in securities of various issuers. In particular, that section divides a fund’s assets in two baskets, one representing 75% of the fund’s assets and one representing the other 25%. The restrictions focus on the 75% basket: its assets must consist of “cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities.” With respect to “other securities,” a fund may not include in the 75% basket securities of a single issuer accounting for more than 5% of the fund’s assets or constituting more than 10% of the issuer’s voting securities. The 25% basket of the fund’s assets escapes the restrictions. To obtain favorable tax treatment, a mutual fund must also meet IRS diversification requirements.

31. Investment Company Act § 12(d)(1). In 1996, Congress relaxed the prohibition with respect to funds investing in other funds in the same group or “family” of funds.
32. According to the SEC, an illiquid asset is defined as an asset that may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued its investment on its books. Investment Company Act Release No. 14,983 (Mar. 12, 1986).
Rule 35d-1 under the Investment Company Act provides that a fund may adopt a name that suggests particular investments or investments in a particular industry, provided that the fund has adopted a policy to invest at least 80% of its net assets in investments suggested by its name.\(^3\)

§ 6:4.3  Restrictions on Capital Structure

In addition to the above provisions which generally serve to regulate advisory services and fees, other requirements of the Investment Company Act focus directly on a fund’s capital structure. These provisions include restrictions on debt, issuance of redeemable shares, and pricing of shares.

[A]  Prohibition on Debt Issuance

Section 18 of the Investment Company Act sharply curtails the issuance of senior securities. The purpose of this provision is to control the use of leverage and therefore the risk to common shareholders by limiting the volatility of their investments and to prevent the abuse of purchasers of senior securities that could result from fund speculation.

Section 18(f) prohibits the issuance of any senior security by an open-end company, except for bank borrowings. In the event that a mutual fund does borrow from a bank, it must, immediately after the borrowing, have asset coverage of at least 300% of all borrowings.\(^4\)

[B]  Issuance of Redeemable Shares

Investment Company Act section 22(e) provides that open-end companies may not suspend the right of redemption, and must pay redemption proceeds within seven days. The act provides flexibility from this provision only in limited instances (for example, certain emergencies or for such periods as the SEC may by order permit).

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33. A fund may adopt a name that suggests that it focuses its investments in a particular country or geographic region, provided that it has adopted a policy to invest at least 80% of its assets in investments that are economically tied to that particular country or region and the fund discloses in its prospectus the criteria the fund employees use to select those investments. Accordingly, a fund’s name may reflect its investment objectives, its fund family or series affiliation. Investment Company Names, Investment Company Act Release No. 24,828 [Aug. 18, 2001].

34. For purposes of these requirements, the term “senior security” is defined in Investment Company Act § 18(g) as “any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends.”
[C] **Pricing of Shares**

The Investment Company Act sets forth requirements regarding the pricing of fund shares. Mutual funds are required to value their shares daily on a “mark to market” basis. Specifically, Rule 22c-1 requires that an open-end fund may not be sold or redeemed “except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security.” This is commonly referred to as “forward pricing.”

§ 6:4.4 **Restrictions on Sales of Fund Shares**

Having examined the Investment Company Act’s regulation of advisory services and the fund’s capital structure, we now look at the act’s regulation of the sale of fund shares.

[A] **Limits on Sales Load**

Section 22(b) of the Investment Company Act sets forth a general prohibition on unconscionable or grossly excessive sales loads, to be defined by a registered securities association, such as FINRA. Under existing FINRA rules, the maximum sales charge may not exceed 8.5% of the offering price of mutual fund shares. The amount is scaled down in steps to 6.25% if investors are not offered one of three additional benefits: dividend reinvestment at net asset value, quantity reinvestment at net asset value, or rights of accumulation.\(^{35}\)

[B] **Financing Distribution Through Fund Assets**

Originally, the SEC took the position that an adviser was not permitted to use fund assets for distribution expenses. This position was based on the SEC’s belief that existing shareholders did not benefit from larger fund asset bases, the adviser did. Because of this, fund distribution was generally financed by sales charges paid by the purchaser. If no sales load was charged, the adviser typically paid all distribution expenses.

The use of fund assets to finance distribution was revisited, and in 1980, the SEC adopted Rule 12b-1, which permits the use of fund assets for distribution subject to procedural safeguards. This change in position was grounded in the belief that use of fund assets to pay for distribution could benefit investors by increasing the size of the fund, which might lead to economies of scale.

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35. NASD Conduct Rule 2830.
Advertising Regulations

While an investment company is registered under the Investment Company Act, its securities are registered under the Securities Act. The Securities Act has a very strict framework governing written communications (for example, advertisements) used in the sale of securities. In particular, written offers relating to securities must satisfy the requirements of section 2(10), 5 or 10 of the Securities Act, which generally provide that such written offers must either meet the standards of a prospectus or be excepted entirely from the definition of a prospectus. In short, what has developed is a structure where investment company marketing material generally must fall within one of three categories to avoid being subject to the full array of rules that govern a statutory prospectus. Two categories of advertisements may be used as well as a category called “supplemental sales literature.” The two types of advertisements that may be used to market investment company shares are: Rule 482 advertisements and Rule 135a generic advertisements. Rule 482 provides funds with a great degree of flexibility with respect to both content and form. Virtually any information may be presented so long as it is not false or misleading. Notably, Rule 482 ads may show performance information. If total return performance is shown, the rule generally requires uniformly calculated one-year, five-year, and ten-year average total return quotations (typically referred to as “standardized performance”). Nonstandardized performance information may also be included if accompanied by standardized performance. In addition, standardized yield information may be shown, but not nonstandardized yield. If performance information is included, the ad must also include certain cautionary disclosures. A Rule 482 advertisement is not permitted to include or be accompanied by a purchase application.

Generic advertisements, permitted by Rule 135a under the Securities Act, are allowed to contain only general information about investment company securities and not about a particular investment company. Generic advertisements are not as popular as Rule 482 advertisements because they are limited to providing only very general information about investment company securities.

In addition to the two categories of advertisements discussed above, communications that are “preceded or accompanied by” a statutory prospectus are permitted to be used as marketing communications. This type of communication is referred to as “supplemental sales literature” and is excepted from the definition of a prospectus. Supplemental sales literature may include a wide range of material. In contrast to Rule 482 ads, which are restricted to including only the performance information specified in the rule, supplemental sales
literature can include other performance information. Nonstandardized performance must be accompanied, with equal prominence, by standardized performance numbers.

In addition to the SEC regulations governing investment company advertisements and supplemental sales literature, these communications are generally subject to FINRA rules. This is because broker-dealers selling investment company shares are typically members of FINRA and therefore subject to its rules which, among others things, apply to investment company marketing material. The primary rules in this area are NASD Conduct Rule 2210, which establishes standards for communications with the public, and Rule 2211, which governs institutional sales material and correspondence. These rules establish standards regarding the content of communications and the circumstances under which material must be filed with FINRA.

§ 6:4.5 Administration of the Investment Company Act: The Role of the SEC

The SEC’s Division of Investment Management has primary responsibility for administering the securities laws affecting investment companies. The Division is headed by a director and several associate directors. The Division is broken down into various offices, including those handling rulemaking, disclosure documents, applications for exemptive orders, and interpretative questions raised under the Investment Company Act.

SEC pronouncements relating to investment companies emerge in a variety of ways, including rulemaking, exemptive orders, enforcement actions, and through requests for “no-action letters.”

Understanding these various sources is important in order to understand the administrative gloss that has developed over the Investment Company Act’s provisions. Of note, Congress gave the SEC a significant amount of discretion in administering the Investment Company Act through rulemaking and exemptive authority. In this way, Congress attempted to balance the act’s heavy-handed regulatory approach.

[A] SEC Inspections

Rule 31a-1 under the Investment Company Act requires that investment companies maintain specified books and records relating

36. No-action letters include all letters to the SEC staff requesting advice, interpretation, opinions, or assurances that no enforcement action will be recommended by the staff to the SEC under given circumstances. “No-action” refers to the staff’s written responses to such requests, which are generally public.
to their investments, shareholder accounts, and other aspects of their operation. The SEC is authorized by statute to inspect these books and records. The SEC’s Office of Compliance Inspections and Examinations (OCIE) inspects mutual funds and advisers to determine whether they are complying with applicable rules. Pursuant to this provision, SEC staff conducts periodic inspections of the operations and records of investment companies to monitor compliance with the Investment Company Act and to remedy deficiencies.

[B] Enforcement

Under section 42(b) of the Investment Company Act, the SEC can conduct formal investigations pursuant to subpoena power. The SEC is also authorized, under section 9(b), to bring administrative proceedings against persons associated with investment companies, and under section 42(d) to bring actions in federal district courts to enjoin continuing and future violations of the Investment Company Act. Section 49 of the act provides for criminal prosecutions of violations.

§ 6:5 Application of the Investment Advisers Act

Advisers to mutual funds are also subject to regulation under the Investment Advisers Act. As such, they live with the provisions imposed by that act with respect to the imposition of performance fees, principal and agency cross trades, and compliance policies and procedures, to name just a few.