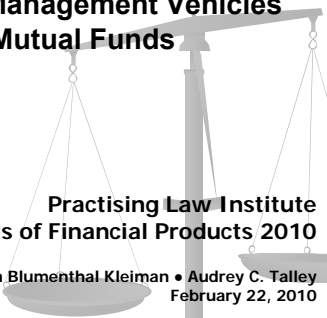


**Introduction to
Investment Management Vehicles
and Mutual Funds**



**Practising Law Institute
Nuts & Bolts of Financial Products 2010**

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**What is an
Investment Company?**

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What is an Investment Company?

- Typically a professionally-managed pool providing the investor with an interest in a combination of one or more types of securities.
- Different types of registered investment companies
 - Open-end
 - Closed-end
 - Unit investment trust ("UIT")
 - Exchange-traded fund ("ETF")
- How do investment companies differ from other investment management vehicles?

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**Raison D'etre:
The Inspiration for
Investment Company Regulation**

- “Because a mutual fund may be viewed as an entity that enters into contracts with others, some of whom are affiliates, regulation is aimed at **ensuring that these affiliates do not overreach the mutual fund and its shareholders.**”

- “In addition, because the assets are liquid and portable, the regulation seeks to **ensure that the assets are maintained in a secure arrangement and are not misappropriated by persons with access to the assets.**”

Background



1920's: World War I is over, business is booming, Wall Street is thriving. Many investment companies are highly leveraged closed-end funds sponsored by, and affiliated with, investment houses.

1929: Investors lose millions. Closed-end fund shares begin “trading at a discount” to net asset value. Unit investment trusts and open-end funds (“mutual funds”) gain popularity.



Mid-1930's: Problems grow in the fund industry. Fund sponsors take advantage of their affiliations with funds to use fund assets to their own benefit.

1935-40: At Congress' request, the SEC conducts the *Investment Trust Study*, a comprehensive study of the fund industry. Congress holds hearings on the study.

Background

August 22, 1940: The Investment Company Act of 1940 is enacted.

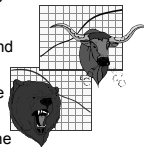
1940's-1960's: Bull markets: Investments in open-end funds grow.

1970's: Bear markets: Mutual funds hit with massive redemptions; money market funds take off.

1980's-2000's: Investments in mutual funds – and the rules and regulations governing the fund industry – increase.

2000-2003: The tech bubble bursts, and a slowdown in the world economy follows.

2004-Present: Capital markets rebound, investments in mutual funds increase ... until the credit crisis and recession.



Background

Investment Company Assets¹ (\$ in billions)

	Mutual Funds ²		Closed-End Funds		ETFs ³		UITs	
	\$	#	\$	#	\$	#	\$	#
1940	0.5	68						
1950	2.5	98						
1960	17	161						
1970	48	361						
1980	135	564						
1990	1,065	3,079						
1995	2,811	5,725	143	500	1	2	73	12,979
2000	6,965	8,155	143	482	66	80	74	10,072
2005	8,905	7,975	277	635	301	204	41	6,019
2006	10,397	8,117	298	647	423	359	50	5,907
2007	12,000	8,024	313	664	608	629	53	6,030
2008	9,601	8,022	188	646	513	743	29	5,984

¹ Source: Investment Company Institute, 2009 Investment Company Fact Book (49th ed.), available at http://www.icifacbook.org/pdf/2009_facbook.pdf

² Mutual fund data excludes mutual funds that primarily invest in other mutual funds.

³ ETF data prior to 2001 were provided by Strategic Insight Simfund; ETF data include investment companies not registered under the Investment Company Act of 1940 and ETFs that invest primarily in other ETFs.

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Regulation and Regulators

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Regulation and Regulators

- **At the heart of mutual fund regulation are regulations to enforce fundamental principles set forth mainly in the Investment Company Act of 1940:**
 - Restrictions on transactions with affiliates, to prevent dumping, self-dealing and fee layering
 - Restrictions to ensure liquidity, diversification and safekeeping of assets
 - Requirements to ensure accurate and adequate disclosure
- **Other relevant federal statutes include:**
 - Securities Act of 1933
 - Securities Exchange Act of 1934
 - Investment Advisers Act of 1940
 - Internal Revenue Code of 1986
 - Sarbanes-Oxley Act of 2002

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Regulators

Securities and Exchange Commission ("SEC"):
main federal agency regulating registered fund activity, specifically via the

- Division of Investment Management
- Division of Enforcement
- Office of Compliance Inspections and Examinations ("OCIE")

Other important regulators include:

- Financial Industry Regulatory Authority ("FINRA")
- State securities commissions ("blue sky authorities")
- Commodity Futures Trading Commission ("CFTC")
- Internal Revenue Service ("IRS")
- Department of Labor ("DOL")

Compliance -- the Self Regulator



- **Rule 38a-1** requires that each fund adopt and implement a robust and tailored compliance program of policies and procedures "reasonably designed to prevent violation of the federal securities laws"

- **Chief Compliance Officer** -- In addition, each fund must appoint a CCO with sufficient authority and resources to effectively enforce the program

Fund Anatomy

Redemption distinguishes mutual funds from other registered investment companies



- Mutual ("open-end") funds must issue shares that are **redeemable at the option of the shareholder** every day at net asset value
- Definition of "**redeemable security**"
 - "Any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer ... is entitled ... to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." (Section 2(a)(32))

Redemption distinguishes mutual funds from other registered investment companies



- Mutual funds are priced and sold at net asset value every day
- In contrast, closed-end fund shares typically
 - are sold in one-time firm commitment underwritings
 - are not redeemable and rely on exchange listing and/or tender offers to provide share liquidity

Redemption distinguishes mutual funds from other registered investment companies



- Mutual fund redemptions can be **suspended in only very limited circumstances**, like:
 - When the NYSE is closed or trading is restricted
 - If there's an emergency during which disposal of the securities is not practicable
 - If the SEC gives you an order permitting you to suspend redemptions

Exchange-Traded Funds (“ETFs”)

- **Definition**

- Open-end funds or UITs registered under the Investment Company Act and certain other funds or trusts that are not “investment companies”
- Generally issue and redeem shares or units in sizeable aggregations (“Creation Units”), at net asset value, principally in kind in exchange for a basket of its portfolio securities.
- List shares or units, which are individually non-redeemable, on a securities exchange and trade at market prices.

- **1940 Act ETFs**

- Must file an exemptive application with the SEC to permit the fund to offer and redeem Creation Units and to list such shares or units on a securities exchange

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Exchange-Traded Funds (“ETFs”)

- **Scope of 1940 Act ETFs**

- Initially, the SEC authorized exemptions for index-based ETFs; subsequently, the SEC extended relief to ETFs holding a portfolio of securities included in a debt securities index. Some 1940 Act ETFs invest primarily in preferred stocks
- In February 2008, the SEC authorized “actively managed” 1940 Act ETFs

- **Non-1940 Act ETFs**

- Certain funds or trusts that are not required to be registered as investment companies under the 1940 Act may be termed “ETFs” if they sell and redeem Creation Units on a continuous basis and list individually non-redeemable shares or units on a securities exchange
- Shares or interests typically registered under the 1933 Act on Form S-1

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Fund Anatomy: The Role of the Board

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Fund Anatomy: The Role of The Board

- Each mutual fund is an individual issuer, organized under the laws of an individual jurisdiction, typically:
 - Delaware -- corporation, statutory trust, partnership or limited liability company
 - Massachusetts -- business trust
 - Maryland -- corporation



- Governed by a board of directors, partners or trustees
- Independent (or "disinterested") directors are the "independent watchdogs" of the mutual fund industry
--*Burks v. Lasker* (U.S. Supreme Court 1979)

Fund Anatomy: The Role of The Board

- In order to be "independent," directors generally may not:
 - be affiliated with, or have a family member who is affiliated with, the fund, its investment adviser or its principal underwriter
 - during the past 6 months, have executed trades with, distributed shares of, or loaned money to, the fund, any affiliated fund or its investment adviser
 - during the past two years, have acted as legal counsel to the fund or have otherwise had a "material business or professional relationship" with the fund
 - beneficially own shares of the fund's investment adviser or principal underwriter (or control persons of the adviser or principal underwriter)

Fund Anatomy: The Role of The Board

- Charged with oversight of (among other things)
 - Advisory and distribution arrangements (including fees)
 - Portfolio transactions
 - Selection and retention of independent auditors
 - Nomination and election of new independent directors
 - Valuation procedures
- Advisory contracts must be approved by a majority of a fund's independent directors (Section 15(c))
 - Advisory fees must be "reasonable" and must be annually re-evaluated by the fund's independent directors
 - Section 36(b) gives shareholders a private right of action for unreasonable advisory fees
 - *Jones v. Harris Associates* may change current controlling principles with respect to advisory fees in mutual fund litigation

Fund Anatomy: The Role of The Board

- Like the advisory agreement, a fund's underwriting arrangements must be approved by a majority of the independent directors
- Rule 12b-1: distribution of fund shares can be financed with fund assets only pursuant to a written plan (a "Rule 12b-1 plan") approved annually by a majority of the independent directors
 - Directors must determine annually that the plan is "reasonably likely to benefit the fund and its shareholders"

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Fund Anatomy: The Role of The Board

- Section 10 requires that independent directors comprise at least 40% of a mutual fund's board
- In 2004, the SEC adopted controversial rules that would have required that most mutual fund boards:
 - Comprise at least 75% independent directors
 - Have an independent chair
- In 2005, the DC Circuit Court remanded the rules on the grounds that the SEC did not do an adequate cost/benefit analysis. *Chamber of Commerce of USA v. SEC* (June 21, 2005)
- Legislation currently pending before Congress, however, is similar to the SEC 2004 rule amendments and, if enacted, would reinstate the 75% independent director requirement



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Fund Anatomy: The Supporting Cast

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The Supporting Cast: Investment Adviser(s)

- **Investment adviser:**
 - Must operate pursuant to a written agreement approved by the board and shareholders
 - Must be registered under the Investment Advisers Act of 1940
 - Responsible for management of portfolio assets
 - Often also responsible for administration, valuation, and shareholder servicing, unless that function is handled separately by a fund administrator (which may or may not be an affiliate of the adviser)
 - May delegate certain management responsibilities to one or more sub-advisers

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The Supporting Cast: Investment Adviser(s)

- The adviser is also typically the mutual fund's **sponsor**, who:
 - Develops **investment objectives, policies and strategies**;
 - Oversee various **organizational matters** of the fund;
 - Effects **registration** with the SEC and the states;
 - Provides **seed capital** of the fund;
 - Chooses the **initial directors**; and
 - Serves as the fund's **initial shareholder**.



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The Supporting Cast: Distributor and Dealers

- **Fund Distributor:**
 - Fund shares are sold via a **principal underwriter** who is **registered under the Securities Exchange Act of 1934** and a **member of FINRA**
 - Also must operate pursuant to a **written agreement** that must be approved initially and annually by the board
 - The distributor may, on behalf of the mutual fund, enter into **selling agreements with one or more broker-dealers**.

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The Supporting Cast: Distributor and Dealers

- **Distributor and/or dealers** may be responsible for, among other things:
 - Printing and distributing **disclosure documents**;
 - Complying with **state and federal offering requirements**;
 - Identifying **potential investors** and responding to **shareholder inquiries**;
 - Devising effective **advertising** or maintaining a **sales force**;
 - Executing **purchase and redemption** transactions; and
 - Providing other **investor services** not provided by the adviser or administrator.

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The Supporting Cast: Custodian

- Assets must be safekept with a "**qualified custodian**" (Section 17(f)):
 - Generally a **bank**, a member of a **national securities exchange** or, in limited circumstances, the fund itself
 - Rule 17f-4: custody arrangements with permissible **depositories**
 - Rules 17f-5 and 17f-7: **foreign custodians** and depositories



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The Supporting Cast: Transfer Agent

- **Transfer agents** are responsible for:
 - the **issuance, transfer and redemption** of shares; and
 - the **opening and maintenance of shareholder accounts**.
- May be affiliated with the fund's investment adviser, custodian or other fund affiliate.



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**The Supporting Cast:
Auditors**

- **Independent auditors** (Section 32)
 - Selection of the fund's independent accountants **must be approved by a majority of the fund's independent directors**
 - Under the **Sarbanes-Oxley Act**, independent directors must identify and retain the auditors. The act also imposes additional restrictions on services auditors may provide to the fund and its affiliates



**The Supporting Cast:
Legal Counsel**

- **Fund Counsel**
 - General legal advice with respect to the fund.
 - Also may handle matters such as fund organization, preparing filings with the SEC and state blue sky authorities, drafting or reviewing fund contracts and assistance with the fund's compliance program.
- **Independent Directors' Counsel**
 - Neither applicable law nor industry best practice explicitly require directors to hire counsel.
 - Nevertheless, and in the light of the recent scrutiny of the fund industry, fund industry groups now strongly recommend that independent directors retain legal counsel and other experts at the fund's expense.



**Fund Anatomy:
Portfolio Restrictions and
Guidelines**

**Portfolio Restrictions and Guidelines:
Diversification**

- **Diversified fund** under the 1940 Act (Section 5) means that, with respect to 75% of its portfolio, the fund:
 - Can invest a maximum of 5% of its assets in any single issuer; and
 - Can own no more than 10% of the outstanding securities of any single issuer.
- **Non-diversified fund** complies only with the IRC Subchapter M diversification requirements (Section 851(b)(3)), meaning that:
 - The fund must meet the 5% and 10% limits only with respect to 50% of its portfolio; and
 - With respect to the other 50%, no more than 25% of the fund's portfolio can be invested in any single issuer.

**Portfolio Restrictions and Guidelines:
Transactions with Affiliates**

- **Broad restrictions on transactions with affiliates** (e.g., advisers, brokers, dealers and funds) (Sections 10 and 17)
- **Exemptive rules** permitting transactions involving affiliates subject to strict conditions include:
 - **Rule 10f-3** (acquisition of securities during the existence of an underwriting syndicate)
 - **Rule 17a-7** (principal transactions between affiliated funds)
 - **Rule 17a-8** (mergers between affiliated funds)
 - **Rule 17a-9** (the money market fund "bailout" rule)
 - **Rule 17d-1** (transactions between funds and affiliates)
 - **Rule 17e-1** (transactions with affiliated brokers)

**Portfolio Restrictions and Guidelines:
Funds of Funds/Securities-Related Businesses**

- **Restriction on investment in other investment companies ("funds of funds")** (Section 12(d)(1))
 - No more than **3%** of the outstanding voting stock of the acquired fund
 - No more than **5%** of its assets invested in the acquired fund
 - No more than **10%** of its assets invested in funds in the aggregate
 - Special provisions for investment in funds in the same complex
- **Restrictions on investment in securities-related businesses** (Section 12(d)(3))

**Portfolio Restrictions and Guidelines:
Liquidity/Quality/Fund Names**

- **Liquidity**
 - A mutual fund may invest **no more than 15% of its assets** in **“illiquid securities”**
 - Money market funds are limited to 10%
- **Special money market fund rule** (Rule 2a-7, as amended on January 27, 2010)
 - Minimum **quality** requirements
 - Maximum **maturity** requirements
 - Daily **liquidity** requirements
 - **Redemption processing** requirements for shares that have “broken the buck”
- **“Misleading names rule”** (Rule 35d-1)
 - Must invest at least 80% of assets in securities suggested by the fund’s name

**Portfolio Restrictions and Guidelines:
Leverage**

- Mutual funds offer one class of common stock -- **no “senior securities”** (Section 18(f))
 - No debt
 - No warrants
 - No preferred stock
- **Leverage** for mutual funds is limited to bank borrowings (Section 18(f)(1)), and the fund must have 300% asset coverage--for every \$1 of leverage, fund must have \$3 of unleveraged assets
- Closed-end funds have more leverage flexibility
 - If they borrow, they must maintain 300% asset coverage
 - If they issue preferred stock, they must maintain 200% asset coverage (Section 18(a)(1))

**Portfolio Restrictions and Guidelines:
Leverage**

- Some instruments in which mutual funds invest can have **the effect of leveraging the portfolio**:
 - Futures contracts
 - Uncovered written options
 - Reverse repurchase agreements
- **To avoid leverage**, a mutual fund that invests in these instruments must **“segregate assets”** to cover its obligations
 - “Tag” on the fund’s books liquid assets that are valued at least 100% of the market value of the obligations, marked to market daily

**Portfolio Restrictions and Guidelines:
Pricing and Valuation**

- Fund portfolio net asset value must be **based on market prices**, if available, or fair values (Section 2(a)(41))
- Every mutual fund shareholder is entitled to receive net asset value for his/her/its shares every day
- No such thing as “conservative pricing”
 - **Price too high:** favors the redeeming shareholder over the purchasing shareholder and dilutes the remaining shareholders
 - **Price too low:** favors the purchasing shareholder over the redeeming shareholder
- Mutual fund share prices must be based on “forward pricing”

**Portfolio Restrictions and Guidelines:
Pricing and Valuation**

- **Mutual Fund Pricing Abuses:**
 - **Market timing (not necessarily illegal):** buying and selling mutual fund shares in the hope of profiting from anticipated short-term upward or downward market moves, often to exploit share prices that are based on **stale closing prices** of securities established some time before the fund calculated its own share price.
 - **Late trading (always illegal):** trading after the fund’s pricing (typically 4 p.m.) with the goal of profiting from after-the-close information (i.e., “**backward pricing**”) instead of receiving the next-determined share price (i.e., “**forward pricing**”).

**Portfolio Restrictions and Guidelines:
Pricing and Valuation**



TYPICAL MARKET TIMING
 (“STALE PRICE ARBITRAGE”)
 OF A JAPAN FUND
 (All times are Eastern Time.)

DAY 1				DAY 2	
before 4:00 p.m.	4:00 p.m.	5:00 to 7:00 p.m. or so	7:00 p.m.	1:00 a.m.	before 4:00 p.m.
Timer buys shares following an event (perhaps merely a rally in the U.S. markets) that portends a rise in the Japanese markets.	U.S. markets close.	The fund effectively backward prices shares by using the stale 1 a.m. closing prices of its Japanese portfolio securities to calculate its NAV .	Japanese markets open and rally in response to the event.	Japanese markets close.	Timer redeems shares, realizing a gain and reducing the return of long-term investors.

Fund Anatomy: Sale of Fund Shares

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Sale of Fund Shares

- Mutual fund distribution subject to retail price maintenance (Section 22(d)):
 - Mutual funds are sold subject to a variety of sales charges:
 - “Front-end load”: deducted at the time of purchase
 - “Contingent deferred sales load” (“CDSL” or “back-end load”): imposed at redemption, based on the amount of time the shares were held
 - “No-load”: shares sold without a front-end or contingent deferred sales load or ongoing trail
 - “Trail commissions” – an ongoing asset-based charge that finances distribution pursuant to Rule 12b-1

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Sale of Fund Shares

- “Asset based sales charge” rule: fund sales charges are regulated via the entities who sell them by NASD Rule 2830
 - In June 2009, FINRA proposed new Rule 2341 to replace Rule 2830
 - Proposed Rule 2341 would revise the disclosure requirements regarding cash compensation received from fund companies

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Sales of Fund Shares

- **Multiple-class funds:** "classes" are defined by different sales charges and ongoing fees
 - Requires written **18f-3 plan** approved by the board

Class	Arrangement
A:	"Traditional Front-end Load" -- front-end sales charge; often subject to breakpoints; sometimes with a trail
B:	"Traditional Back-end Load" -- contingent deferred sales charge coupled with trail; often converts to Class A after a specified period
C:	"Level Load" -- short-term CDSL with trail; no conversion
I:	"Institutional" -- no-load
R:	"Retirement" -- lower loads for retirement plans

Fund Anatomy: Registration and Disclosure

Registration and Disclosure: SEC Registration

- Investment companies **dually register** under the Securities Act of 1933 and the Investment Company Act of 1940
 - All funds register on Form N-8A
 - Open-end ("mutual") funds register on Form N-1A
 - Closed-end funds register on Form N-2
 - UITs register on Forms S-6 and N-8B-2

Registration and Disclosure: Disclosure

- Central to good practice in any securities offering is **accurate and adequate disclosure**
- 1940 Act requires that a fund disclose, among other things:
 - Its **investment objectives, policies and procedures**
 - Its **service providers and the fees** it pays them
 - **How it sells its shares**, including sales charges and related fees—and whether it permits, discourages or prohibits “market timing”
 - How it **values its portfolio holdings and, consequently, its shares**

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Registration and Disclosure: The Components

- **Fund disclosure has been a hot topic for over 25 years**
 - **1978:** Form N-1 replaces Form S-5
 - **1983:** Form N-1A replaces Form N-1 with a **two-part disclosure Format**
 - **2009:** SEC adopts comprehensive mutual fund disclosure initiative
- **Part A--the “simplified prospectus”**
 - “[A] **concise presentation of certain information** [that] meets the requirements of Section 10(a) under the 1933 Act, and, therefore, can be used to satisfy the prospectus delivery requirements of Section 5(b)(2) of the 1933 Act.”
 - Part A must be delivered before or concurrently with the purchase of shares

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Registration and Disclosure: The Components

- **Part B--the “statement of additional information” or “SAI”**
 - “[M]ore detailed discussions of matters required to be in the prospectus, as well as discussions of certain matters that are **not required to be in the prospectus**, but which may be of interest to at least some investors.”
 - Not automatically provided, but must be available free of charge upon request
- **Part C--the “Part C”**
 - Provides **information for the SEC**, including a list of exhibits, certain information about the fund’s adviser and distributor and the location of books and records
 - Is filed with the SEC only, but is accessible via EDGAR

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**Registration and Disclosure:
The Components**

- **New: Risk/Return Summary and the Summary Prospectus**
 - In January 2009, the SEC adopted form amendments that require a summary section at the front of a mutual fund's prospectus, which would include:
 - ✓ Investment objectives
 - ✓ Fees table, including portfolio turnover information
 - ✓ Principal strategies, risks and performance
 - ✓ Investment advisers (and sub-advisers) and portfolio managers
 - ✓ Purchase and redemption procedures
 - ✓ Financial intermediary compensation
 - Summary may be used to satisfy prospectus delivery requirements
 - Required for updates or new filings made on or after January 1, 2010

**Registration and Disclosure:
The Components**

- **New: Extensible Business Reporting Language ("XBRL") Requirement**
 - On February 11, 2009, the SEC adopted rule changes that require a mutual fund to include the risk/return summary section of its prospectus on the fund's website and the SEC's website in the Extensible Business Reporting Language ("XBRL") data format
 - The rule changes became effective on July 15, 2009
 - Mutual funds must comply with the XBRL interactive data requirements by January 1, 2011



**Looking Ahead:
What's on the Horizon**

**What's on the horizon
with respect to:**

- The Financial Crisis
 - Implications for the SEC
 - Potential legislation and regulation governing banks, derivatives, OTC options, broker-dealers
 - Implementation of changes to money market fund regulation
 - Registration of private fund advisers
- *Jones v. Harris*
- Valuation Guidance
- The Continuing Saga of Rule 12b-1
- ETF market share
- More Enforcement?
