Mutual Funds w/ Frankel

9/1/09

Industry was scared of giving SEC a lot of authority in the Investment Company Act, so they spelled a lot out. Later, they realized they were frozen in time by the scope of the act, so they got ability of SEC to condition exemptions from the act.

As such, it may be helpful to examine if there have been exemptions to any section of the act that we read.

- Money: Allows an efficient means of trade using a standardized measure of worth, also allowing a simplification from a strict barter system.
- Open-end funds:
    - Managed Funds
    - Shares redeemable any time
- Closed-end funds:
    - Managed
    - Shares non-redeemable. Can only liquidate by selling in secondary market
- Unit Investment Trust:
    - Unmanaged
    - Redeemable
- ETF
    - Unmanaged (portfolio linked to fixed format, e.g. S&P)
    - Redeemable for large shares, which as dividable into non-redeemable shares.

What do you need to create a market?

- Standardized documents to unify valuation and minimize cost of same.
- Must be a sufficient number of financial assets to trade.
- Sufficient number of potential buyers/sellers.
- Intermediaries.

What is the difference between an

- Underwriter: Buys the shares in an IPO and sells to individual buyers, thereby assuming all risk in creation of the secondary market.
- Broker: Drum up and sell to buyers. Fiduciary Duty.
- Dealer: Sell to buyers, but don't provide information & deal w/ sophisticated investors so no fiduciary duty.

What do investment managers do?

- Two possibilities:
    - Examine the company about to offer shares (issuer).
        - Determine "intrinsic value."
            - Present value of discounted future income.
        - Usually done for IPOs and small companies.
    - Look at market prices and compare them to issuer.

Note: §18 does not allow leverage (borrowing to increase your potential rewards). This is risky. If you only use your own money, that's all you can lose. Closed-end funds are permitted very limited leverage, section 18A.

Diversification: §5 requires some, as does the Tax Code. How do we deal w/ this issue?

9/3/09

1920s, people were rushing to buy stock, and brokers were stoking that fire. They had "trusts" that they bought into.

Differences between then and now:

- Trusts were highly leveraged. (§18(f))
    - Presently, a fund is allowed to borrow from a bank only with a tremendous amount of collateral, e.g. to cover a large unexpected redemption.
- No transparency in 1920s
- Lots of funds of funds, which compounds the risk of the leverage. (§12(d)(1))
    - Presently, funds allowed to be up to 3% another single fund, and 10% other funds in aggregate.
- Trusts suffered from dilution, where insiders bought low and sold high, thereby passing the cost on to the remaining shareholders and diluting those shareholders' value. (§22, 23)
    - NAV – Net Asset Value (§2(41))
    - Issues of market timing.
- In a trust, discretion of the trustee is highly limited.
- Corporations have a much larger scope, and particularly in the age of the conglomerate *ultra vires* (acting outside of corporate discretion) is not at issue.
    - Investment policy of 1920s investment corporations was wide open. (§7, 8, 35)
- Dumping (§10(f))

Presently,

- Goldman, etc. would create a corporation with which it would put a number of shares of other things. Goldman (the Advisor) makes a K w/ the corp s.t. the Advisor becomes the director(s) of the corp.
    - §10(a) and §2(a)(19) require 40% disinterested directors
        - There are about 10 exemptions to this, which typically allow 50 or 51% of *disinterested* parties.
    - K is governed by §15 and §36(b). Typically no or minimal assignment of trustee is allowed.
    - Originally, §29 talked about the dates that the time would apply. When it was transferred into the USC, the section numbers were bungled.
        - 5 USC §80(a).
- Sales and disclosure governed by §24.
- Conflict of interest issues covered under §
    - Banks don't have conflict of interest regulations much because:
        - Banks are debtors. They give you an IOU. It's debt, not equity.
        - Mutual fund managers take risk at *the investors'* expense, not *their own*.

What does an advisor need to manage money?

- Advisor must have skin in the game in the fund.
- Hire portfolio managers
    - Have analysts under them.
- Brokers – vehicle for purchasing assets.
- Lawyers

- Accountants
- Compliance Managers

Note that ownership of the operations of an investment corporation is outsourced to the Advisor. This is problematic in that it has high ongoing people costs, and needs to make sure that the income from its fiduciary business covers the expenses.

- Putnam was a huge mutual fund, owned by a large insurance co. It has a lot of money from pension funds. The president engaged in conflicts of interest, as did many of the managers. The pension funds found out, and withdrew their money. Putnam was then sued by both the SEC and the investors.
    - No trust in the advisor remained.

9/8/09

Grading:
30% Participation
70% Exam – 24hr, looking for going to the right authorities and express in a way demonstrating.

Investment company act aimed at solving certain problems:

- Feature that brings about problems.
    - Assets are liquid (e.g. financial assets)

Focus on the SEC:

- SEC is a political organization – Commission is appointed by president.
- Three members are members of President's party, two are of the opposition party.
- President chooses chair.

Today:
1: Exemption
2: No Action Letters
3: Enforcement

Statute gives SEC the authority to change the law for everyone or only one entity.

- Exemptions:
    - SEC can give declaratory decisions/exemptions under three sections.
    - SEC has power to make declaratory decisions – can decide, for example, if a person or institution has "control" of something. §2(a)(9)
    - E.g. under another section, 40% of the board of a mutual fund must be independent of the advisor, and there are 10 exemptions in which the 40% became 50%.
    - 6(c) gives VERY broad leeway to the SEC to exempt pretty much any group from any or all provisions of the Act.
        - Burden of persuading the SEC that an exception is (1) appropriate, (2) in the public interests, (3) consistent w/ protection of investors, and (4) in line w/ purposes of the Act lies on the applicant.
    - 17(b) only allows exemptions for *proposed* actions, thus *past* exemptions cannot be retroactively exempted.
        - SEC allows applications under both 17(b) and 6(c) to receive retroactive exemptions.
- Limitations on acquirements:
    - Cannot acquire more than 3% of your assets from a single fund
    - Cannot acquire more than 10% of your assets from any collection of funds.
    - Cannot allow more than 5% of your assets to be acquired by another fund.
    - Why?
        - The further down the chain you are, the fees materialize more.
        - Issues of transparency
        - Potential conflict of interest for advisor.
        - Issue of fund A, which has invested in B, directing transactions of B by threatening to redeem shares.

                - Considering *Vanguard* on p.36, costs for Vanguard lowered due to having investors who leave their money in for a long time and have predictable withdrawals.
    - How do you apply for an exemption?
        - You write an application.
        - Before handing it in, you go talk to the SEC staff.
        - Receive comments and conditions
        - Redraft application
    - Can the parties sue the SEC for not awarding the exemption?
        - Only if you can demonstrate an arbitrary or corrupt decision.
- No-Action Letters
    - Letters by the staff in which they assure the applicant that they will not recommend action to the commission.
    - They have become precedential over time.
        - 1. Comes from an authority
        - 2. Published and public
        - 3. Authority is consistent
        - 4. Promise not to change it retroactively
            - Can rely on them. Commission will not sue.
            - No guarantee that a private party will not sue
                - Exemption removes private cause of action.
    - Judges cite no action letters as an authority, as SEC is expert-agency.
    - Process:
        - Go to staff. Give all relevant facts. Negotiate w/ staff.
- Enforcement
    - There are presently a variety of proposals to tighten the regulation tying together brokers, dealers, broker-dealers, planners, etc.

9/10/09

Rules under:

- Investment Company Act: 17 CFR § 270
- Investment Advisors Act: 17 CFR § 275

- 15 U.S.C.A. § 80b-2
- Investment Advisors Act
- Investment advisors are, generally, anyone who receives any economic benefit in exchange for investment advice.
- Requirements:
    - **Advice/Information**
        - Given on a **regular basis** *if* distributing advice via letters.
            - (If via letter, not a personal service and likely more analysis than advice. Analysis requires frequency.)
    - Relating to **securities**
    - For **compensation**.

- If one is an investment advisor, whether knowingly or otherwise,
    - If act applies can become a fiduciary, with all duties that attach.
    - Must register
- Issue re: registered representatives.
    - Definition is VERY broad with sweeping exceptions (e.g. banks, lawyers, accountants, engineers and teachers)
    - Note §2(11)(C) excludes any broker (act as agents; buy *for* a client) or dealer (act as traders) whose investment advice is incidental to his services **AND** does not receive any special compensation therefore.
    - If advisor covers less than $25mil, they are regulated by the state, not the SEC.
        - $no requirement to register if under $30m, and no requirement to deregister if over $25m.
- What is a fiduciary?
    - Someone who provides a service
        - That is costly to acquire
        - Important to society
        - Of great import.
    - Entrusted with property or power
    - There is associated risk
    - Remedies for violation will include not only remedy of damages, but also punitive damages.
- Investment Advisors Act §36(b) prevents advisors from charging unreasonable / unfair fees.
- Note that many rules in fiduciary law are default rules.
    - E.g. waiver of conflicts of interest are (usually) nonbinding.
        - Can be binding for specific transactions, but not generally.
- Old case (1963; p. 63)

    - Advisor was buying shares, advising clients to buy, and selling at a gain without disclosing this to the clients.
    - Essentially the issue is that the *conflict corrupts the advice*.
- Registration

9/15/09

Problem with incentivizing mutual fund advisors with a percentage of the assets, which usually means that gains translate to higher compensation, it can be artificially inflated due to sales of the fund.

A mutual fund only grows through (1) performance or (2) increased sale of shares. A number of people are trying to get fees, and so has an interest which is aligned with the investor re: (1) and not with (2).

Registration Issues:

- Who must register?
  - Corporate advisor (if corporate)
  - May also have to register the individual players.
- Monetary Threshold
  - If over 30 million AND more than 16 clients
- Where do you register? State v. Federal
  - Form ADV
- Form ADV-S : Annual update
  - How do you find out if there are material changes?
  - Build relationship w/ client
- Brochure Rule
  - §206 is fraud rule.
  - §206 (4) puts a number of requirements in.
  - Advertisement is defined (§206(4)-1(b)) very broadly.
    - Is it an ad?
    - Does it pass the sniff test?
      - Revise as necessary.
    - May have to file it with FINRA or the SEC.

9/17/09

- Brokers used to give soft dollars back to managers, which were sometimes diverted to sales rather than given back to the shareholders.
- Of the big investment organizations: pension funds, banks, insurance and mutual funds, insurance companies are (largely) regulated by the states.
- Note that structure of a mutual fund is s.t. they essentially cannot fail.
- What is an investment company?
    - Issuer: leads to "Person" which leads to "company"
    - Company includes a fund.
- Prudential (p. 86)

9/22/09

What tests does this section provide for an Investment Company?

3(a)(i)(a)

- "Security" §2 (a) (36) p. 7
    - This is HUGELY broad.
    - Security is tradeable.
        - This requires standardization
            - Investment contracts different because they are more personalized, and somewhat distinct.
    - Anything that is a security in the eyes of the public. (Amazingly broad)
    - Every security of a security is a security.
    - W. J. Howey (p. 94)
        - Sells plots of land to people, and advocates to use a profit-sharing agreement to cultivate crop.
        - The combination of the land and the service constitutes an investment.
        - It doesn't make economic sense to buy or sell just 18 trees, so it is the standardization or packages that are pooled together that makes this a security.
        - Also, it involves a fair bit of risk, has the expectation of profit, and profits are generated by the efforts of others.
    - Bank of America (p. 105)
        - Banks are excluded from the investment company act if regulated under US law (Canadian law added later)
        - Is a Canadian bank sitting on a lot of promissory notes.
        - SEC views as securities because the notes are pooled together.
    - Pooling of assets (not financial assets) does not constitute a security.
    - Look at §3(a) p. 11
- Fifth Avenue (p. 103)
    - You can become an investment company inadvertently.
    - Bus Company get foreclosed upon by NYC, and seeks payment for same.
    - Claimed to want to get control of subs, at which point they would be a holding company, and thus an operating company, not an investment company.
        - Congress did not want to regulate holding companies.
        - See §3(b).
- SEC Exemption under Rule 3a-4 (p. 95)
    - Wrap-around programs
        - Very expensive (~3% of assets under management)
        - Requires contact w/ client ever 2 mo.
        - Client gets hand-holding
        - Unique design of portfolio
        - Advisor has right to terminate the relationship.
        - Redemption in kind
            - Take your securities and leave us alone.
        - Each client's securities held in their own name.
            - Personal account for each client.

3(a)(i)(c)

- Company that engages or proposes to engage in business of investing, owning, or holding securities (government and cash excluded) worth over 40% of its assets.

9/24/09

- Looking at Fifth Avenue, the court left unanswered exactly when it became an investment company.
- SEC passed Rule 3(a)(1)
    - Company has one year after becoming liquid to attempt to acquire another business, and then has to apply for an exemption.
- Talked about (3)(a)(1)(C)
    - One of the words there was "holding," which we don't find in A.
        - DuPont family constituted investment company under C and not A because there was no selling of stock – they *held* the stock.
    - It is an investment company under (C) if over 40% of its assets are investment securities, government securities and cash excepted. This is because (a) many operating companies would qualify as investment companies. Also, there is theoretically no risk to either.
- National Presto (Supplement, p. 11)
    - SEC wanted Presto to apply for an exemption, Presto refused.
    - SEC decided to make an example of them.
    - Most previous exemptions were conditioned on investment income feeding into the operation side, rather than vice-verse.
    - Factors for operational/investment company decision:
        - History
        - Representation
        - Activities of offices/directors
        - Nature of assets
        - Source of Income
    - Government securities mean *issued* by the government, not guaranteed by it.
- 40% rule is by value as defined in 2(a)(41)
    - Use market value if exists.
    - If not, board of directors decides what value is
- ICOS (p. 110)
    - Have to spend at least all of your investment income, which prevents reinvestment, to prevent becoming an investment co.
    - Must be spent on operations (R&D).
    - Must be invested in conservative assets to show that it is preserving the funds.
- Why not submit to regulation under Investment Company Act?
    - Cannot borrow
    - Regulation over who can control
    - Must have disinterested board of directors
- §3(b)
    - Provides esceptions for 3(a)(1)(C)
    - Note that falling under 3(b) is different from an exemption, as 3(b) companies are *not* investment companies, whereas SEC exemptions allow investment companies to not have the law apply to them.
- Private Investment Companies
    - §3(c)(1)
    - Cannot offer publicly
    - No more than 100 investors

9/29/09

Financial Intermediaries

- Mutual Fund
- Pension Fund
- Insurance
- Banks

Some things may not be clearly (under §3(b)(1))) be conducting a financial business, but fall under the categories of mutual funds/financial intermediaries because they issue and invest in securities.

One exclusion (3(c)(1)) exempts companies with less than 100 beneficial owners and no public offering. Beneficial ownership is governed by 3(c)(1)(A), which requires reference to 2(a)(42) (Definition of "voting security").

- §7(d) – Private offerings do not (necessarily) trigger the act.
- Under the 1933 act, a private offering is OK. However, under 1940, a foreign company issuing shares in US has other obligations under 3(c)(1).
    - This is less an issue of protecting US companies, and more a fear that US companies would go abroad and be subject to far less stringent regulations.
- Management paid a percentage of assets under management, and also gets a fee based on performance of the funds, which may be paid in shares rather than cash because they have risk of depreciation.
- 3(c)(7)
- Under advisors act, need not register if less than 15 investors.
    - Also created subsidiaries that invest in them.
    - Rarely organized as organizations; usually a limited partnership.
- 3(c)(2)
    - Intermediaries (generally) excepted
- Derivatives
    - Take a contract (e.g. a future) and turn it into property that can be traded.
- 3(c)(3)
    - Banks, insurance, savings & loan are excepted, and all are regulated on their own.
    - Bank is allowed to pool client trusts, SO LONG AS IT DOES NOT ADVERTISE.
- Factors
    - People who buy accounts receivables.
- Another exemption is for charities
    - They invest in assets to increase their pool to use for charitable purposes.
    - Regulated by IRS.
- Pension Funds
    - Regulated under ERISA
    - Excepted under 1940 act.
        - Conditions.
            - Established by bank or insurance co
            -

10/01/09

Investment companies did not want a rule allowing banks to securiturize. As such, rule had to be limited to essentially non-investment companies.

For next time, read Supplement 172-174.

October 6, 2009

Liquidity issues make for problems because if there are no buyers, you can't sell, and the price is likely lower.

Requirement to hold for 10mo before a security becomes redeemable, it is redeemable upon presentation and so is a redeemable security.

Class is examining Rule 270.3a-7 (p. 172), SPV can reinvest, but has to do so in the same kinds of assets to remain non-mutual funds.

Issuer can only acquire securities in the same type of security or otherwise indicate what they will invest in at the outset.

Perfection (legal): Your securities are secured or similar such that they will be paid prior to other investors in case of inability to pay.

October 8, 2009

Registration of Mutual Funds requires 2 registrations:

1) Registration of the fund (company) itself
2) Registration of the securities that it issues.

Usually we only require registration of the securities – why in the case of mutual funds do we require registration of the company itself?

It is somewhat equivalent to Articles of Association, and may serve to prevent the board from dramatically and unilaterally changing the fund's makeup.

What happens if you don't register?

- Company's contracts are unenforceable.
- The recital in §8(a)(1) is particularly important to lawyers.
    - Pay close attention to the SEC's instructions, which are based on a lot of thought by the staff.
-

Note that 7(d) only talks about public placement, thus any foreign company that meets the requirements of 3(c)(1) can offer without registration.

It is criminal not to issue a prospectus (§12(a)), and to make a misstatement if there is intent, materiality and causation (§17)

Also a requirement for disclosing the affiliates of a mutual fund, see definition of Affiliated Company and Affiliated Person (p. 3)

10/15/09

Last class we discussed disclosure, leaving open the question of disclosure through electronic means. What is the justification of preventing investors who do not have a computer from receiving prospectuses? It seems that most investors are computer-savvy enough to use them

Manager incentivized to keep assets under management, and so will use a reducing rear-end load to incentivize investors to stay.

Risk disclosure

Tabankin (p. 185)

- Fund invests in currencies
- Characterized investments as "conservative" and strategy as "prudent."

Hyperion (p. 187)

- One advisor and three closed-end funds.
- One fund was in mortgages, which risked prepayment if interest rates dropped.

October 20, 2009

To what extent are mutual funds subject to disclosure requirements for securities?

- Mutual funds are always registered.
    - Note that you would have to register again if issuing identical securities at a later date.
- Open end funds continuously offer securities (to grow and to offset redemptions), and thus must continually update their registrations.
    - How do we balance continuing registration and cost reduction?
- Advertising is thus linked to registration in mutual funds.
- Mutual funds are not traditional corporations, and thus the information that they offer to people must be adjusted to reflect that difference.
- See § 34(b) (p. 82)

Registration: What's in the prospectus, and what kinds of prospectuses do we have?

- 1933 Act, § 5(b)(1) (can't sell or offer to sell unless you have an effective registration statement)
- §2(10) (tells you what is and is not a prospectus)
- Under §482, you can add information so long as there is a prospectus
    - Note: A recorded phone message may require a prospectus if the information therein does not comply w/ §5.

Van Kampen (196)

- Incubation fund, intended to show "pure performance" without issues of public distribution, registration, etc.
- Funds asset base was very small.
- Investments were in early stages of small IPOs.
- Problem is that as the asset base increases, they cannot maintain the small IPO investments.
- §17(a) of '33 Act, which prohibits misleading statements or omissions of material facts (with intent) made it illegal to claim that they would use substantially the same management practices when that was an impossibility.

Disclosure of Abusive Trading Practices

- What is market timing

October 29, 2009

Norm Nichol – Boston SEC, Attorney Advisor

SEC does 3 types of exam:

- Routine – Happens automatically on a routine basis
- Cause – In response to a complaint, etc.
- Sweep -

November 03, 2009

Soft Dollars:

- Asd
- Broker Dealers are interested more in selling because it involves a cash inflow.
- Brokers would rather trade within a fund family because the same transaction fees can be obtained for less trouble/money.
- In ’86, SEC opened the door for small brokers to purchase research to give back to funds in the form of soft dollars.
- Catalog: The soft-dollar offerings of the brokers to the advisors. At what point is this “research?”
    - Research is OK. Other things are not.

Contract btw Fund & Advisor:

- §15
- Fees: §36(b)
- It is possible that the advisor company might work for more than one fund.
    - Consider Vanguard, which is actually owned in part by its funds.
- Advisor would prefer to have a contractual rather than ownership relationship w/ the funds, as that way the underlying entrepreneur has more control and reaps greater reward for their risk, but has to put up more money.
- Prevents assignment
- In an open end fund, the underwriters sell all the time to offset redemption and then grow the fund.
- Note that under §15(c) directors must meet in person.
- Note §46(b) (p. 90)
    - Contracts that violate the chapter are void and unenforceable, **unless** a court decides that enforcement is more equitable.

Fees:

- Amount under management can grow through performance, but even more through sales.
- Accordingly, try to grow the fund with both methods.
- Breach of fiduciary duty: §35 (p. 82), specifically (b) on p. 83
    - Advisor entitled to compensation for services
    - Advisor has fiduciary duty with respect to the amount of those payments, and accordingly must be **very** careful when they decide how much they will pay themselves.
- Krinsk (247)
    - Read this and Jones v. Harris for next time.
    - Have a Cash Management Account (CMA) that operates effectively as a money market that loose case in other investments (e.g. from dividends, etc.) can be swept into so that the cash can grow.
    - Management fee grew with the popularity of these accounts.

- Fees are more important than meets the eye. First, because they create a compounded interest effect.
- Note that in Hedge funds, something like 20% of performance goes to the manager.
- What, then, is wrong with performance fees in the mutual fund context?
    - Leads to a situation where managers are encouraged to take risks as they don't share in the downside, but share in the upside.
    - There is a related risk of speculation.
- Economies of scale in the mutual funds context come from the fact that you don't spend *as much* on managing a particular amount as you would on managing double. In other words, cost of management does not increase directly in proportion with amount of assets under management.
    - Decreased marginal cost of management as assets under management increase.
- Krinsk:
    - Look at nature and quality of services provided
    - Profitability for adviser.
        - Consider fees like 12(b)-1
            - Basically, a fund can't generally finance advertisement for itself, UNLESS it meets a laundry list of conditions s.a. 1) plan approved by shareholders; 2) approval by majority of board; 3) approval by majority of *disinterested* directors (defined in 2(a)(19)); etc.
    - Fall-out Benefits
        - Things that come from the service, but are additional and not paid for by the servicee.
    - Economies of Scale
    - Consistency w/ industry norm prices
    - Trustees' Approval
- Rosenfeld
    - Lazard merges into D&B (Moody's). Thus two advisors merging.
    - Ks for management disappeared as new advisor came in.
        - This resulting in merging the funds.
    - Lazard got K to provide some services the consolidated entity, and Moody's to manage it.
    - Moody's giving shares to Lazard for the merger, which is problematic as Lazard is profiting from sale of its management interest.
    - Got shareholder approval
    - Court holds that Lazard was too involved in the transfer transaction, and thus cannot take shares in exchange for services.
- §15(f) – Legislative response
    - Can:
        - Can sell management interest and get $$
        - Congress allowed an advisor to sell shares of itself, s.t. controlling shareholder can change.
    - Must have:
        - 75% of board disinterested including at time it approves the K.
        - No unfair burden on the investment company.

- Can’t increase fees, etc. w/o good reason.

November 10, 2009

Issues that concern the mergers of not advisors, but funds.

- First, the form of the funds may be different – e.g. one may be a corp and the other a business trust.
- Becomes particularly complicated when one of the merging corporations has exemptions. BE SURE THAT THE SURVIVOR HAS REQUIRED EXEMPTIONS.
- Must vote for **any** change in the investment policy. (§8)
- Boards must ensure that valuation of other's shares is fair and accurate.

Corporate Governance

- Federal law does not preempt state law in this area. They must live together.
- Burks v. Lasker (269)
    - Shareholder can sue, but has to either make a demand or allege that demand is futile.
    - Note that independence is a different concept as between the Investment Company Act and state corporate law.
        - In the Investment Company Act, Interestedness is a status (§2(a)(19))
            - Note that on top of the Act is the SEC's ability to declare by order that someone is interested by reason of having had a material business or professional relationship with such company or its principal executives, underwriters, affiliates, etc.
        - Under corporate law, Interestedness is with regards to a specific transaction
    - Derivative suit.
    - Disinterested Ds want to terminate it.
    - P complained that directors violated duties under Investment Company Act by purchasing CP that lost money due to the CP issuer's fraud.
    - SCOTUS found that federal law does not preempt state law, and thus BJR applies with regards to director decisions.
        - Issue is that either federal preemepts state or state preempts federal.
        - There is no terribly clean answer here.
    - Note that state law, particularly with respect to corporations, is much more developed than federal law.
    - Accordingly, organization and business decisions are governed by state law while independence of directors is handled by the 1940 Act.
    - SCOTUS effectively allows federal and state law to coexist.
    - Blackmun talks *in his concurrence* that state law must be interpreted consistently with federal law.
- §16 & 36(a)
    - Under corporate law, the rest of the directors can fill board vacancies.
    - §16 disallows this in the Investment Company aspect.
        - If you have 3 vacancies, you must go to the shareholders – Can't replace directors by filling one vacancy at a time
- Requirement re: Independent director's lawyer (???)
- Strougo (279)
    - Demand excused as futile in case of fund director who sat on board of a number of funds as pay is quite high and conflict of interest is likely.
    - Still, cannot *impose* a different board on each fund.

    - Duty of Care
        - Impartiality. Can't treat one shareholder differently than another.
- As directors, what questions would we like to ask the advisor?
    - Investment strategy
        - Who are our experts?
        - What's their track record?
    - What do the funds fees look like?

November 12, 1009

If you look at the balance sheet of a mutual fund:

- Its assets are securities (the ones it invests in)
    - §12 limits involvement with insurance, etc.
- Its liabilities are securities (the ones it issues)
    - Other liabilities related to normal business, but minimal in comparison.
    - §2(a) (32) – Redeemable Security.
        - Note that it has to be redeemable *instantly*, so **not** a redeemable security if the issuer redeems once every seven days.
        - While most funds redeem for cash, they *can* redeem for the pro-rata shares.
            - ETFs: ETF issues Creation Units, and gives them to underwriters, etc. in exchange for securities.
            - The Creation Units are then broken down and sold to the market.
        - Note that if you allow only investors with account values less than $5k to redeem, you effectively have different classes of shares.
        - §18(i) – Management companies must (generally) have *voting* stock.
        - In an open fund, you typically have one class of stock:
            - Cannot have senior and junior securities – prevents abuse of leverage.
            - Means that redemption is uniform across investors.
        - §41 – Value:
            - Generally mark to market, otherwise directors have good-faith responsibility to price it.
            - Broker who offered the security is a likely expert re: its current value.
                - Potential conflict of interest re: pricing.
            - Another "expert" might be the manger who bought it
                - Still incentivized to inflate price.
            - Board would like to value but doesn't know how. Experts may have conflict of interest, so the actual price of the good is sometimes squirrely.
    - §19 – Payments/Distributions
        - Cannot distribute *long term* capital gains more than once a year, *so long as it's in violation of SEC rules, mandates, etc.*.
            - She doesn't think the SEC has any such rules, so this is not active law.
        - Avoid Ponzi schemes.
        - Prevents the fund from returning assets, either of the investors or of others, to investors under the guise of being profits.
- §8 – Ultra Vires still exists!!
    - Must be description in company's registration as to its investment policy.
    - §35 Name must correspond to investment policy.
- Voting §18(i)
    - Shareholders entitled to vote.
    - §15 requires vote on advisory contract.
    - §16 shareholders must vote for directors.
    - §??? Shareholders must vote for independent accountant.
        - Has been ameliorated under certain circumstances.
    - §8 requires vote for *certain* changes in fund policy.

November 13, 2009

Insiders:

- A significant risk that insiders will either use the information themselves or share it with others.
- §17(j) – See rule 17j-1 (p. 260)
- §38 of ICA gives SEC authority to promulgate rules.
    - Question is whether the authorization under a specific section serves to narrow the authorization under §38.

Code of ethics is required.

- Why ask the individual advisors to set out their own code of ethics?
    - Difficult to draft a set of rules that can be applied across the board.
- If the rules are violated, the advisor is liable under the rules.
    - The employee is not liable to SEC. Employer can enforce code of ethics to avoid liability.
- Regulation FD (book p. 384)
    - Congress was concerned with companies that went abroad and kept both their activities and profits hidden from the US.

§12(b)

- Note that at one point there was no rule, and so many people felt that there was no prohibition on doing things.
- SEC interpreted it as meaning that it was unlawful *unless* SEC had a rule that allows it.

November 17, 2009

- Sales of mutual funds are tightly related to fees that the advisors charge.
- Fees are a percent of assets
    - Must be related to management of the assets and cost of same.
- §22(d)
    - Some brokers enticed buyers by selling shares for less than market price.
    - Brokers are, however, allowed to compete on their own commissions.
- Note that mutual fund shares must be paid in *cash* (or equivalent), and so cannot pay with IOU.
- Can buy shares on margin (see p. 419), but fund has to be paid upon tender of the share.

Conflict of Interest

- Four sources of controls that affiliates and affiliates of affiliates must consider:
    - §17(a) – controls of transactions in which the other party is the principal
    - §17(d) – Joint transactions
    - §17(e) – affiliates act as agents
    - §10(f) – affiliates act as underwriters.
- §17 (p. 46)
    - Affiliate §2(a)(3)
        - Talks about control, presumptions in §2(a)(9)
        - 5% owner or 5% owned, employees, directors, investment advisors
            - Note: Not the underwriter.
        - Each of these categories has affiliates, and affiliates of affiliates are captured under §17(a)
        - Add promoters to the list of those under §17.
    - Prohibited actions:
        - (1) sale of any security or other property to a registered company *or* any company controlled by a registered company *unless*
            - [exceptions omitted from notes]
        - (3) borrowing money or other property from a registered company or a company controlled by same, except as in §21(b).
        - (4) loaning money to a registered company or a company controlled by same.

Looking at the study questions on p. 428:

a. Generally transactions between two affiliates of an investment company are allowed so long as the IC doesn't own one.
b. If the IC is involved, transactions between it and an affiliate or an affiliate of an affiliate are problematic.
c. Looking at c., if it is clearly not an attempt to get around §17 restrictions (e.g. old brokerage company owned by insurance co-affiliate), SEC will usually consider them to be separate companies.
d. Hypo: We have a bank, which issues loans and puts them in a wholly-owned sub, which in turn issues the bank common stock. The sub then issues preferred shares to investors.
    a. First, is the sub an investment company? It is clearly an issuer that issue securities and invests in securities.
    b. Next, if it is an IC, what is the bank? It's clearly an affiliate, and so absent an exemption you have a problem under §17.

- §17(e) is very similar to 17(a) except that it puts the affiliates in a position of being agents.
    - We can't prohibit agents in the same way that we can principal transactions.
    - Note that if you act as a broker, 17(e) has some restrictions in (2). Underwriters have no restrictions under this section.
- §17(d) restricts joint transactions.
- §10(f) prevents underwriters from dumping whatever they couldn't sell into mutual funds.

November 19, 2009

Exemptions to §17(a)

- Do not exclude insiders (promoters, affiliates, etc.)
- Third tier affiliates are out.
    - Except if one affiliate is really the long arm of the second one.
    - May be similar to piercing the corporate veil rationale.
- Investments not including the IC or a controlled co. are out.

Tally Indus. (438)

- Tally is an affiliate of an IC.
    - T owns 9% of IC.
- Tally CEO wants to acquire another co, American and buys shares.
- Manager at IC sees price of A go up, so also buys some.
- Issue is that if they both aim at the same acquisition, IC may get a bad deal as compared to the affiliate.
- American went to court and sought injunction under §17(d).
    - Court dismissed.
- A tried another suit under '34 Act re: proxy materials, likely §14
    - Court denied injunction
- IC and T need SEC approval for proxy statement, and denies injunction under §17(d)
- SEC approves the proxy materials, and requires them to get exemption.
- Hearing for exemption, and it is denied.
- Factors for a finding of joint action:
    - Relationship between the parties:
        - Knowledge of one another's actions, communication, etc.
    - Nature of the investments and their effect on the market.

Means to repair conflict of interest:

- Blind Trust: You don't know what is being done w/ your money in the trust.
- Automatic Investment Plan: Depending on a number of conditions, do certain things e.g. on the first of every month.
    - This way you have no ability to use inside knowledge inappropriately.

Deutsch (444)

- §17(e) – conflicts of interest of agents.
- An agent is someone who has power over someone else's property and is able to bind the principal to legal obligations.
    - 17(e) uses a less formalistic conception, where the agent is anyone acting on behalf or in the interests of the principal (IC).
- Court separates agency from specific actions. He has the *ability* to bind them, and thus is an agent.
    - Court says that he has influence, and in fact *any* VP is an agent in the §17(e) context.
- The court here finds that the combination of actions and actors indicates a case of agency of conflict of interest.
- Deutsch liable even though Mills reaped the vast majority of benefits as he got prestige benefits.

Question:

- Can a fund's VP act as an agent for compensation?
- If relationship is contractual and not doing anything for company that he is a VP for, he likely isn't an agent and thus can do what he wants.
- Suppose the fund's lawyer knew about Mills' activities.

§10(f)

- Dumping of hard to move shares by an underwriter is illegal for a period of time. After a year (or so) the presumption of dumping can go away.

For December 1, read 462-472

November 24, 2009

Rule 2a-7 (p. 149) changes the usual valuation as in 2a (41).

- Changes form of reporting
- Changes permissible way of computing value from market to amortized cost method or penny-rounding method.
    - Amortized cost method is tied to what the fund paid for the asset
        - More stable
- Limits what a **money market fund** can invest in
    - Length (time) of investment
    - Quality of investment

December 1, 2009

Exam:

- About 5 questions
- Identify the issues
- 7000-8000 words (10-11 pages)
- Show some kind of research – know where to go to get current answer.
- Pros v.Cons
- Look at the statute/rules to find answers.
    - Cases
    - Exemptions
    - No Action Letters

Notes:

- For a very long time there was only a single case where a court found the SEC did not have the authority to do what it was trying to.
- Now, there have been 3 cases in the last ten years limiting the SEC's authority. They are based on a narrow, limiting interpretation of the statute.
- Professionalism v. Ethics
    - The "loop-hole lawyer"
- Carter (521)
    - Two attorneys tried by SEC under Rule 2(e) for aiding and abetting violations by client.
    - Under 2e SEC can disqualify lawyers from appearing and practicing before SEC if they have engaged in improper conduct.
        - Can't prepare letters, opinions, arguments in writing. Can't touch securities regulation professionally.
    - How to get into trouble:
        - Recognize that a situation must be disclosed
        - Continue to represent the client despite non-compliance.
    - Here, the real question is: When do you resign?
- Kaye Scholer (529)
    - Large firm, however most of its attorneys worked for this one client.
    - Firm back-dated a document.
- Gutfreund (536)
    - Rule was that brokerage house could only bid for clients, not for itself.
    - Guy started bidding on things in large amounts, using fictitious of unauthorized clients.
    - Management (including G) was delighted at the amount of money made, and didn't ask for specifics.

December 3, 2009

Room 1144

§28(e) of the ’34 Act governs advisors/directors and fund interactions.

Exam:

- Identify the factors and where they fit within the act (if at all). Then identify the transaction.
- Research elements:
    - Find the right section(s).
    - Find, in the last year or so, similar examples (cases/NALs/etc.) and analogize.
        - Don’t spend all day doing research; only get one source.
- How she would prep:
    - Go through notes.
    - Take the old exam.
    - Start with the facts. Determine what rules apply. Apply them.