Mutual Funds – Fall 2001
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CHAPTER 1
INTRODUCTION TO INVESTMENT MANAGEMENT

A. The Investment Management Industry

1. What do Investment Managers Do?

Two types of Investment Advisors:

- One that offers advice, which investors use in making their decisions
- The other provides investors discretionary management in accordance with guidelines
  - discretionary managers offer their services by pooling small investors' money to create large portfolios, investing the money in securities, and managing these large portfolios.
  - Pooling reduces management expenses and diversifies risk and increases the managers fees by increasing the assets under management

Six core functions of the financial system:

- clearing and settling payments
- pooling resources and subdividing shares
- transferring resources across space and through time
- managing risks
- providing information through prices to facilitate coordination
- dealing with incentive problems.

2. What Methods lDo Advisers and Investment Managers Use to Perform Their Functions and Evaluate Investment Opportunities

The Fundamental Approach
Involves following the performance of particular companies and attempting to identify securities whose prices do not fairly reflect the analyst's evaluation of the company's financial condition

The Technical Approach
The study of the performance of the market itself rather than external factors that affect supply and demand for securities. A chart is made of past movements of common stock prices and trading volume for clues to future price movement

Efficient Capital Market Hypothesis (ECMH)
The hypothesis is concerned with how successful the market is in establishing security prices that reflect the worth of the securities, success being defined in terms of whether the market incorporates all new information in its security prices in a rapid and unbiased manner.

- If true, investors should not be able to outperform the market
- ECMH variations are discussed on page 8

- Random Walk Theory – since price movements of particular stocks are random, no effective systematic way exists to predict which stocks will be the winners and which will be the losers. This theory maintains that the market is efficient, with prices moving so rapidly in response to new information that investors cannot consistently buy or sell fact enough to benefit. Hence, the only profitable investment strategy is to buy and hold randomly selected stocks over a long period of time.

Disclosure of Past Performance

SEC used to not allow a mutual fund company from publishing past performance because disclosure of past performance implies that will receive same in future (this is a misrepresentation).

RULE CHANGE – SEC now allows disclosure of past performance

- SEC wanted competition, comparison nor for future performance but to show market if management is competent
- Rule allows investment company to give performance information for 1year, 5 years, 10 years
- Information must include risk of investments and must break down funds into bonds, equity and treasury bills – include risk of different funds.
- SEC did not create specific performance standards, left it up to individual funds. But once fund decides on how to calculate performance they are locked into that standard.
- AMR created benchmark standard – don't have to use it but if do connotes trustworthiness.

Portfolio Selection: Efficient Diversification of Investment - Harry Mankowitz, page 11,

If correlation among security returns were perfect – if returns on all securities moved up and down together in perfect unison – diversification could do nothing to eliminate risk. The fact that security returns are highly correlated, but not perfectly correlated, implies that diversification can reduce risk but not eliminate it.

What do Investment Advisors Do?

Buying on Margin – buying on credit, the margin is the amount the borrower must invest in order to borrow the rest. For example, to invest $2000 an investor may have to put in $1000 and then can borrow the rest.

- Requiring margin means that if the borrower goes broke, the bank will be even at worst.

Types of Risk

Market Risk – investor takes the risk of the market going down

Political Country Risk – risk of currency devaluation

Credit Risk – Risk of default

Did diversification alleviate all of the above Risk?

- Market Risk – harder to eliminate the risk on long term obligations. Bank loans $100 at 8%. If the interest rate rises to 16%, the loan is only worth $50 because the $8 return on the original loan can be achieved with $50.
- Currency Risk – can be diversified through SWAPs
- Credit Risk – can be diversified by investing in stocks and bonds

Requirements of a Market

- Standardized documents
- A number of traders
- Information about the issuer
- A number of people willing to purchase

3. The Evolution of the Various Advisory Services (e.g., financial planners, asset allocation services, investment companies)

The Boston Trustee

The Boston Trustee offered advice and referred clients to particular brokers for whom they may or may not have received referral fees. The Boston Trustee is considered the investment advisor, he would only offer advise and would not execute the trades. A trustee has full discretion to pick stocks and there is no right of termination on the part of the beneficiary – high liability.

Broker Dealer
Gives "free" advice and is paid for executing the securities transaction

Customized Arrangements
Custom made advice is for particular customers and requires a portfolio design that takes into consideration the particular needs of the client, and continuously adjusts the investment strategy to these needs.

Non-Customized Arrangements
Standardized advice is intended for numerous persons and is guided only by general directions as to risks and returns, types of investments. Investment letters and Mutual Funds offer such mass –produced advice. Investors must decide whether such advice fits them.

Non-Discretionary Advice
The advisor gives the advice the advisee (the investor) and the advisee makes the decision. This gives the advisee more control but is also more expensive because the advisee must perform the transaction themselves.

Discretionary Advice
The advisor manages the portfolio and makes the investment decision themselves. This is cheaper but the advisee has less control.

	Customized / non-customized	**Power**
Trustee	(trustees have high liability because has full power)	Full discretion, beneficiary has no discretion and cannot remove trustee
Advisor	Customized to particular investor's needs	Depends on terms
Mutual Fund	Non-customized (Client picks the fund but the advisor decides the strategy and picks the stocks)	Inherently total discretion given to mutual fund manager
Broker	Customized (can give advice and not have a fiduciary duty – assumption that people will not rely completely on broker's advice)	Depends
Investment Letters	Customized	Non-discretionary – investor makes decision – Fiduciary Duty

4. The Impact of Investment Advisers and Investment Companies on Society and the Financial Markets

Benefits to the Economy
People who manage other peoples' money benefit their advisees and society. They encourage investments in financial assets that result in the transfer of money from savers to borrowers, who, will hopefully make productive use of the money. Furthermore, the money is in the hands of "experts."

Liquidity and Volatility
Markets provide liquidity to investors by finding buyers for their investments. The more buyers the more liquidity and the less likely there will be volatility.

The Place of Investment Companies in the Financial System

(Institutional intermediaries)	**Banks**	**Insurance Companies**	**Pension Funds**	**Mutual Funds**
ASSETS	Cash Bonds Loans (mortgages)	Invests in stocks, bonds, treasury bills Cash Obligations to pay	Cash Invests in stocks and bonds	Cash Stocks Bonds Treasuries
LIABILITIES	Deposits Liabilities to financees – stock and bond holders (8% return)	Policies	annuities	Obligation to pay out what is there – theoretically obligations and assets match (only if redeemable), therefore MF theoretically can't fail
				The Mutual Fund becomes almost like a deposit

5. The ongoing problems manager s pose for investors, the markets and the economy

Why Regulate these Institutional Intermediaries?

Banks, Insurance Companies, and Pension funds are regulated as far as reserve requirements and calculation requirements to ensure that money is in there when people are suppose to get it (in the future – funds and liabilities are not matched).

Mutual Funds – In the 1920s all the investment companies invested in each other and were highly leveraged. Public didn't know what was in individual mutual funds portfolio.

- 1940 Act – requires disclosure and limits leverage.
- Mutual funds can only borrow short term from a bank (no real leverage)
- § 10 regulates "dumping" – the practice where an underwriters' mutual fund subsidiary purchases the excess stock of the u/w at higher than market prices.

Securitization

One form of intermediation between those who save and those who borrow are banks.

- Savers place money into a pool. As a saver, this pooling reduces risk (low risk to put money in savings account). The bank pools the savers' money and issues securities to borrowers (lends money to borrowers) and then borrows pay back the loan plus interest to the bank. This is high risk.

6. The Responses of the Markets to the Problems posed by Investment Companies

Redemption (an open end Investment Company)

Redemption makes assets liquid – mutual fund must keep selling to maintain assets. Management fees are a percentage of assets so as people redeem the managers must continue to sell to keep assets (and thus fees) at same level or to increase. Redemption is a response of problems of abuse of power by managers

Unit Investment Trusts

A fixed portfolio of securities that generally hold bond and debt instruments. The manager has no discretion to change the portfolio – this reduces the investor's risk of a managers abuse of power, but they lose the benefit of expert management of the portfolio.

- the trustee has to make sure that the number of investors in the trust does not decrease.

B. The Pattern of Investment Management Regulation

1. The Federal Statutes: the Investment Company Act and the Investment Advisors Act

The main goals to the regulation of mutual funds:

(1) to prevent fly-by-night operators from creating investment companies - § 14(a) requires promoters to invest seed money in company

(2) Provide better disclosure - § 7, 8, 24 – require registration of the securities of the companies and of the companies themselves

(3) To prevent managers from changing the level of risk of the companies' assets - § 13 requires companies to describe fundamental investment policies in their registration statements and requires a vote of a majority of outstanding securities to change the policy.

(4) Prevent conflicts of interest by insiders - § 17(a) –(f) – restricts or prohibits such transactions except by the Commission's exemption.

(5) Strengthen the control over investment managers - § 10 and 16 – invest special powers in disinterested investors. § 36(b) poses fiduciary duties on insiders regarding the fees they may charge the investment companies. § 9 disqualifies those who have been convicted of serious crimes or securities related wrongs from serving as insiders of investment companies.

(6) Prevent embezzlement - § 34, 17(f) and (g) – criminalize conversion of inv. Company's assets and impose safe keeping measures

(7) To ensure that investment companies who have promised to redeem securities do not break that promise - § 22(c) and (e) regulate the time and price of redemptions

(8) To limit over-leveraged financial structures that pose high risk and confusion to investors - § 18 regulates the financial structure of investment companies.

(9) § 9 and 22 prohibit Ponzi schemes and fraudulent sales practices and limit the sales loads that shareholders pay brokers.

The regulation of investment companies and investment adviser is less concerned with the safety, soundness, and profitability of the advisers, and far more with the terms which advisers impose on investors and the other costs that investors may be required to bear.

<u>Exemptions and No-Action Letters</u>

No action letters and exemptions are sought before the deal is carried out

Section 6(c) allows the commission to exempt any person, security or transaction or any class or classes of persons, securities or transactions from any provisions of the act or of any rule or regulation thereunder. If and to the extent that such exemption is necessary or appropriate in the public interest and consistent w/ the protection of investors and the purposes fairly intended by the policy and the provisions of this act.

- **NOTE:** Section 6D, 9C, 10F, 15F, 17B and 17E authorize the Commission to exempt from these particular sections, under somewhat different guidelines than Section 6C.
- Exemptions are reregulation rather than deregulation – the SEC permits the exemption contingent upon the party complying with certain conditions.
    - For example, money market funds can only be exempted if the SEC removes them from market valuation.
- Exemptions have no precedential power though failure to give a similarly situated party an exemption may be considered arbitrary behavior
- Exemptions give individuals, companies an advantage over others. As a result, exemptions cannot be treated lightly.
    - Exemptions are done on a case-by-case basis. Only after 200 or so exemptions, will the SEC provide a generalized rule, exempting a certain type of transaction. This rule will be put forth in a release. This release may modify the transaction to fit within the law.

- Parties who disagree w/ SEC's refusal to grant an exemption can ask for a hearing. However, hearings are costly and time consuming and can spell the end of an application.

Section 17 – Conflicts of Interest

In corporate law, you must fully disclosure is required to disinterested directors if there is a conflict of interest.

In the investment company context, disclosure must be made to the SEC. The govt serves as the disinterested party.

If there is a transaction prohibited by 17A, 17B allows the interested party to apply for a exemption from the SEC for the transaction.

- **17(b)**: any person may file w/ the commission an application for a order exempting the proposed transaction of the applicant from 1 or more provisions of 17A. The transaction will only be approved if reasonable and fair (to all parties, not just the investment company) and doesn't involve over reaching.
- You can only file for an exemption before the deal goes through (b/c of the words "proposed transaction.") Proposed must mean a planned transaction – must be more than an idea.
    - If the transaction has already occurred, the party can go to Section 6C which does not have the "proposed" requirement. Section 6C is a general section, allowing for broad exemptions. *However,* hardship or horrendous consequences are bases for granting a retroactive exemption under 17B.

Section 6C says the SEC **may** exempt an applicant whereas Section 17B says the SEC **shall** exempt if certain criteria are met. Additionally, Section 6C states that the exemption must be **necessary and appropriate and in the public interest** and **"intended by the policy and provisions of this title"**

- Section 6C therefore, is more difficult to request exemptions under

Vanguard Special Tax-Advantaged Retirement Fund, Inc

In 1970, Congress changed Section 12(D)(1) limited fund of funds. In 1985, Vanguard's Retirement funds wanted a relaxation of this section

- The limitations were:
    - Investment companies is limited in its acquisition of other investment companies by the following
        - Section I says that the investment company can't purchase more than 3% of the outstanding voting stock of another investment company
        - Section ii said that a investment company can't hold more than 5% of the total assets of the other fund.
        - The acquiror can only invest 10% of its assets in the securities of other mutual funds

Why these limitations?

- You don't want the fund of funds to control investment strategy of the acquired fund
- Potential conflicts are prevented where the same trustee or manger runs both the holding company and the mutual fund
- It is also a motivating factor in forcing holding companies to maintain a diverse portfolio

Facts: Vanguard wanted more wiggling power than the 3% limitation – it wanted a 10% cap on the acquistion of voting stock of other funds

- The majority on the Commission agreed for the following reasons
- These are not normal funds – these are pension funds. Pension funds are wonderful customers for mutual funds b/c they invest predictable amounts. The SEC allowed the exemption b/c it didn't want to change the numbers in the Act but it wanted the flexibility to provide for exemptions. Section 6C says "policy of the act." This allows for the changing of the numbers through exemptions.

<u>No-Action Letters</u>**:**
Are recommendations that the SEC staff will not allocate resources to prosecute on the facts presented. No-actions letters are not binding on the Commission and are subject to reconsideration by the staff.

- no-action letters have no textual precendtial value but the SEC must honor the staff's recommendations w/ very few exceptions. To go after people who had received no-action letters would destroy the system.

What are the benefits?

- They provide info re: proposed transactions in the mkt place.
- They alert the staff to possible legal barriers to novel transactions.
- They help reduce enforcement by the SEC and litigation by regulated parties and they leave some room for negotiations that allow for a restructuring of the activity.
- They also publicize the staff's interpretation of the securities laws.
- They keep the SEC's interpretation consistent which benefits business.
- Finally, their binding authority provides a safe haven for those parties who get one.

Drawbacks:

- it is expensive but less so than litigation or exemptive process.
- It is also time consuming.

What if I am sued?

- If I was granted an exemption, I cannot be sued for a violation of the Act. A no-action letter on the other hand, does not foreclose liability. A private suit may still be brought and the no-action letter is merely evidence on my behalf. Theoretically, the SEC can still sue me despite the no-action letter. However, the SEC has taken the position that it will honor no-action letters.

2. <u>Other laws applicable to Investment Mangement</u>

State Laws: under state law, investment managers acting w/ discretion, investment advisers, directors, officers and trustees, are fiduciaries. All owe a duty of loyalty, prohibiting them from using their power over an investors property for purpose other than performing their services.

- Corporate law: appoints surrogates for the investors which may consent to conflicts of interest transactions. However, under the 1940 act, the prohibition on conflict of interest is far stricter than that under state corporate law.

<u>Tax</u>

Investment companies have ***pass-through treatment***. This means that investment companies taxable income is not taxed on the company level but only on the investors level. However, the Tax Code imposes substantial conditions to attain this pass through status such as registration under the 1940 act, diversified portfolios (no more than 25% of the mutual fund's assets go into a single companies'stock) and annual distributions of most income of the companies.

- This means that while the corporations pay taxes and the investors pay taxes, the mutual funds who purchase the securities of the corporations do not.
- **Subchapter M** of the 1940 Act requires mutual funds to distribute 90% of their income per year. If fail to distribute, there is a tripe tax – the mutual fund does not pass through.

<u>Corporate Governance</u>

- Mutual fund managers are experts in the mkts, not in corporate governance. The 1940 Act does not want managers to become involved in corporate governance b/c that is not their area of expertise.
- All managers must worry about is disclosure
- Mutual funds will only get involved when a corporation goes bankrupt and it owns a lot of shares

<u>Self-Regulatory Organizations (SROs)</u>

There is no SRO for the investment management industry. Investment companies don't benefit from SROs b/c

- It is relatively easy to comply w/ the 1940 Act
- The advisers are too large and too diverse a group to comply with uniform standards. Ie. Fidelity is very different than a tiny investment company
- Unlike brokers, advisers do not deal w/ each other in connection w/ their business. Since they don't recommend each other, there is little benefit to being regulated by competitors.
- Advisers seem to thrive on competition, which will be restricted by SROs.
- Advisers compete by using distinct management techniques and various fee structures which sometimes lower fees and expenses. To scrutinize their books & records would reveal confidential info and hurt their competitive advantage.

CHAPTER 2
THE INVESTMENT ADVISERS ACT

A. The Investment Advisers Act: History and Outline

The Advisers Act and the Inv. Company act are based on the premise that investment advisers are fiduciaries of their clients. The services they render are personal and cannot be transferred without the clients' consent.

- the jurisdiction over advisers is split between the SEC and the states

B. The Basic Definition: Who is an Adviser?

§ 202(a)11 Definition of an investment adviser
"any person who, for compensation , engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

- The adviser has to be "in the business of advising" but it does not have to be his primary business.
- "in the business" means the person – (I) holds himself out as an investment adviser or as one who provides investment advice, (ii) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities or (iii) on anything other than rare, isolated and non-periodic instances, provides specific investment advice.
- "Economic benefit" the definition of investment adviser applies to persons who give investment advice for compensation. This compensation element is satisfied by the receipt of any economic benefit, whether in the form of an advisory fee or some other fee relating to the totoal services rendered, commissions, or some combination of thee foregoing.

HYPOs
Employer – giving advice to employees on 401(k)

- must look at what kind of information is given
- if tailored for the individual then would be considered investment adviser
- "stocks are good" is not advice because no real information involved

Insurance - if agent for insurance company then must register as investment adviser

Tax - advice on tax consequences only is regulated by non-1940 Act – not investment adviser

Wills - advice on inheritance is not investment advice

Rating Agencies - registered as investment advisers but arg goes both ways

Exclusions

Entities which are excluded from the act are

(1) banks and bank holding companies
(2) lawyers, accountants, engineers and teachers
(3) broker dealers
(4) publishers and authors

Lowe v. SEC

Lowe's registration as an investment adviser was revoked because of fraud. Lowe continued to publish his newsletter that analyzed securities.

Must ask:

- Was he compensated?
    - Yes
- Did he give investment advice?
    - Yes
- Was it part of his regular business?
    - Yes
- Did he fall under an exception?
    - Is he a publisher of a bona fide newspaper?
    - He is under exception because it contains non-specific investment advice attuned to a particular clients needs or to specific portfolio. As long as the communications remain entirely impersonal and don't develop into a fiduciary person to person relationship then the publication will be within the exclusion.

NOTE

There are two qualifications of the newspaper exception:

(1) Tout – someone who disseminates promotional material
(2) Hit and run tipster – someone who from time to time sends out information on the advisability of buying and selling stocks.

Does the Wall Street Journal fall under newspaper exception?

- yes
- it publishes on a regular basis and publishes disinterested information.

C. The Relationship between Federal and State Law

If you manage $25 million or more, or you advise mutual fund or business development companies or are from a state that does not register investment advisers, you must register with the SEC and are regulated by the SEC. If you are not one of the foregoing, you cannot register with the SEC, you must register with the state.

D. <u>Fiduciary Duty of Advisers</u>

<u>SEC v. Capital Gains Research Bureau</u>

The investment adviser bought stock, then advised his clients to buy the stock and then the adviser sold it for a profit without any disclosure to his clients. This is called <u>scalping.</u>

Is scalping a fraud or deceit upon a client or prospective client?

- Yes
- The SEC can force the adviser to disclose to clients his scalping practices.

Clients assume that the advice given to them has not conflict, advisers function should be to provide total service to client. The court does not say that scalping is prohibited, just says have to disclose such practice to clients.

- By disclosing to client, the client knows not to rely solely on the adviser for advice.
- There is not requirement of proof of intent to injure and cause actual injury. It is enough that the assumptions are undermine (assumption that receiving non-conflicting advice)
- Sometime disclosure not enough when client not able to give informed consent.

Why doesn't law prohibit such trades?

- because people who manage money won't stop trading for themselves. So permit scalping but must disclose.

To who does a mutual fund manager disclose?

- Instead of requiring MF managers to disclose to thousands of investors, the fund managers are prohibited from buying and selling within a period before and after the trade done with other people's money.

E. <u>Registration and Disclosure</u>

Investment advisers register with the SEC by filing an ADV form. Has two parts, one is used by regulators the other is the basis for the advisers disclosure document.

- an adviser's disclosure requirements are on page 78 and 79

The SEC tells the adviser what to say in the prospectus and the brochure. When issuing shares, the buyer cannot ask the issuer questions individually so requires issuers to disclose upfront.

The issuer has a duty to disclose but out for its own interests – so the duty to disclose is similar to contract law.

Advisers have a duty to disclose and are bound by fiduciary law.

Remedies for failure to disclose

False registration statement of securities allows for a private cause of action, however, the investor can only sue if the price goes down.

Advisers can sue for fees if the issuer fails to disclose, but a weakness in adviser laws because fees lower because price lower.

F. Regulation of Advisers

Advertisements

Rule 206(4)-3 governs when an adviser may pay cash referral fee. Three circumstances when can be done and the rule imposes different requirements for the different arrangements:

(1) arrangements with parties unaffiliated with adviser
(2) arrangements with affiliates of the adviser
(3) arrangements where a party solicits clients for impersonal advisory services such as general written materials.

Rule 206(4)-1 governs advertisements. Lists for provisions of fraudulent behavior and one catchall

(1) referring directly or indirectly to any testimonial concerning the adviser or advice
(2) referring to past specific recommendations of such adviser which would have been profitable, unless the ad lists all recommendations
(3) advertisement can't use a graph or chart to say that that graph or chart will determine which securities to buy or sell without prominently disclosing the limits of the graph or chart.
(4) Can't state that will provide free reports or analysis unless furnish it completely free without any conditions or obligations.
(5) Can't contain any untrue statement of material fact, or which is otherwise false or misleading

If the ADV wants to show accomplishments, it must show failures as well.

Fees

Advisers may not take performance fees. Why not?

- Fear that Advisers will invest in higher risk investments because will gain big on the up side with not detrimental effects on the down side.

Hedge Funds, on the other hand, allow for performance fees

- smaller number of large, sophisticated investors, if adviser screws around the investor will withdraw and the adviser will suffer greatly

Rule 205-3 – Allows performance fees if
(1) client has $5000 under management or client has a $1million net worth (definition of a sophisticated investor)
(2) Compensation formula based on gains minus losses over one year
(3) Disclosure to client on ADV form, and
(4) It's an arms length contract

This rule doesn't apply to investment advisers to investment companies. Really only applies to hedge funds.

Advisers get a percentage of the assets, not the gains. The advisers cannot accept gratuities from investors.

Soft Dollars

How they work:

- advisers are approached by broker dealer who says "if you give me $100 dollars of business, I will give you $50 in soft dollars" – meaning research etc.
- If a broker is willing to take 98% of the market price, then the market price is arguable too high and the investor should get the benefit of that 2% and not the adviser. This way the broker charges market price to the clients and the adviser is getting the 2% rebate.
- Soft dollars can lead to conflicts of interest with the portfolio, if one party is given business and does not receive anything in return there is pressure to ante-up. This results in someone always owing someone else for something.

§ 28(e) of 1934 Act – permits brokers to provide advisers with services in return for business if the adviser has discretionary authority over the portfolio. This also includes others with discretion like banks and lawyers.

- In other words, 28(e) allows for kickbacks.
- Kickbacks permissible only in services, not cash
- 28(e) sets forth what can be bought for soft dollars – allows kickback for research purposes only. Broker can either provide research or can give cash rebate which must used to buy research.

Soft dollars are permissible. Disclosure is used to protect investor. Principle – all the benefits that adviser gets from broker have to benefit client (research).

Liability

An Adviser that is sued by the SEC may loose his registration, in some cases this is automatic. If it is automatic, the adviser must go to the SEC for an exemption.

Principal and Agency Transactions

§ 206(3) of Advisers Act – advisers are restricted when (1) the advisers act as principals purchasing from clients or selling to clients, securities from the advisers own accounts (principal transactions) or (2) transactions in which advisers act as brokers on behalf of clients as well as other the other party to the security transaction (agency-cross transactions)

- the advisers act regulates these transactions by requiring that the adviser discloses the conflict of interest and receive the client's consent prior to transaction
- Because the principal bears all the risk, the principal should receive all the benefit.
- Any gained received by the adviser must be approved by the investor.

<u>SEC Release</u>
Basic issue – whether it is permissible for an investment adviser to sell a security or to buy a security from a client

The adviser may not affect a transaction unless he obtains consent after full disclosure. Client cannot grant cart blanche authority but must be told each time by adviser.

CHAPTER 3
WHAT IS AN INVESTMENT COMPANY?

Section 3(a) of the Inv. Comp. Act defines an investment company.

- Sect. 3(a)(1): Investment comp. Means any issuer which
  - (A) is or holds itself out as engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities
  - (B) is engaged or proposes to engage in the business of issuing face-amt certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
  - (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of such issuer's total assets (exclusive of Govt securities and cash items) on an unconsolidated basis.

This definition is very broad

- embraces all institutional and market intermediaries and operating holding companies
- Uses 3(b) to limit the institutions covered by the Act.

Analysis:

1. Is this a company?
2. Is the company issuing securities? The three definitions in 3(a) all require that an investment company must be an issuer defined in 2(a)(22) of the Act
3. If so, does the company fall under A, B or C?
4. If so, is the company excepted under 3(b)?

Who is an Issuer?

1. What is a Company?
   a. <u>Prudential Insurance v. SEC</u>

- Prudential created a variable annuities fund where investor pays certain amounts for a certain period. Investor will then receive certain amounts for a certain period until you die. The amounts that you receive will depend on the performance of the fund.
- Investor pays $ to Prudential. Prudential pools the $ and invests it. Payments to investor will vary (variable annuity) according to the profitability of the investment.
- **HELD:** This is a investment company b/c Prudential did not take on any risk, which is one of the requirements for being a insurance company (insurance companies are outside the definition of investment companies)
  - Variable annuities are different from fixed annuities b/c insurance companies in a fixed annuity are required to pay a fixed amount, no matter what so they bear some risk. Here, all the risk is borne by the investor which is similar to mutual fund investor. Hence, this is a investment company rather than a insurance company.

What is a Security?

- An issuer is a person who issues a security, defined in <u>Section 2(a)(36)</u>

- An investment company is a issuer of securities *and* an investor in securities. If the company does not issue securities, it is not an investment company. If it does not invest in securities, it is not an investment company.
    - **Security** means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral trust certificate, pre-organization certificate…See Section 2(a)(36)
- **SEC v. W.J. Howey Co., (102) –** investment K is defined in Howey as a K or scheme for placing of capital or laying out of $ in a way intended to secure income or profit from its employment
    - Howey operated citrus farms. To raise capital for the operation, it sold portions to investors. There was a land sales K for the portions of the farm and a service K where Howey was given full discretion in operating the land. The investors needed the service b/c they had no right of entry and it was inefficient to do anything else but to enter into the service K.
    - Howey thought that by separating ownership from management, he would not have to register as an investment Co.
    - **HELD:** an investment K for purposes of the Securities Act is a K, transaction or scheme whereby a investor invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidence by formal certificates or by nominal interests in the physical assets of the enterprise. The transactions in this case clearly involve investment Ks as so defined.
        - The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities.

Status of Investment Advisory Programs under the 1940 Act

- Rule 3a-4 provides a non-exclusive safe harbor from the definition of investment company for certain investment advisory programs.
- Any advisory program organized and operated in accordance w/ the rule is deemed not to be an investment company w/in the meaning of the Investment Co. Act.
- This permits wrap fees where one fee provides the execution, administration and commission.
- The rule permits similar advice to be given to many people by the same adviser. The giving of similar advice is by coincidence – the adviser has many clients with similar objective so it happens that he sometimes gives them the same advice. If the rule is complied with, he won't be an investment company.
    - The Rule requires the adviser individualizes each investment strategy to each client and that the adviser be available for consultation. The client must be able to receive disclosure documents w/ re: to their accounts and to exercise control over their investments.

Definition of Investment Company by the Nature of its Business and by the Nature of its Assets

- In addition to requiring an entity to be an issuer of a security, it must also fall under 3(a)(1)(a) or 3(a)(1)(c).
  - (1)(a): the entity is an investment company if it is an issuer that is or holds itself out to be engaged primarily, or proposes to be engaged primarily, in the business of investing, reinvesting, or trading in securities.
  - (1)(c): focuses almost entirely on the composition of the company's assets. An entity is an investment company if it is engaged in or proposes to engage in the business of investing, reinvesting, holding or trading in securities and owns or proposes to acquire investment securities having a value > 40% of the issuer's total assets (exclusive of govt securities and cash items on an unconsolidated basis)

- **<u>SEC v. 5th Avenue Coach Lines, Inc</u>.**
- 5th ave. operated a transit system in NY. NYC condemned its assets but eventually 5th avenue received 11.5 million dollars. The company invested 90% of the award.
- Issue: whether or not the company was holding itself out to be an investment company.
  - There are 2 tests: (1) intention of the party (3(a)(1)(a) or; (2) what did the company look like, not what it intended. You look at the company's assets and see if 40% of the company's assets were invested in non-government securities. (3(a)(1)(c))
  - Under the first test, you look at the focus of the company. Who are managers and what are they looking to achieve. The language here is "primarily
  - Under the 2nd test, you look at all the assets. Here, SEC had argued that 5th ave. became an investment co. once they received the cash. Ct disagreed, stating that company should have a reasonable amount of time to decide what to do about the money before being considered an investment company. The question becomes, does the company merely want to diversify its assets or does it want to become a money manager?
    - SEC has determined that company has 1 year to decide what to do.
    - What objective factors should be used when answering this question? Is there an intent to trade? What % ownership is there in companies you invested in? What have you done to look for operating companies to invest in? What % of your assets do your investments consist of?
- Under the 2nd test, if more than 40% of a company's securities are investment securities, then a company is an investment company. Since value of investment securities is based on market value, a company has time to sell securities if they become worth more than 40% of the companies's total assets. (**NOTE** that assets does not include government securities or majority owned subsidiaries (defined in Section 2(a) as 50% or more))

Bank of America Canada No-Action Letter

- Issue: are promissory notes securities? A security which may not be a security under the 1933 act may still be considered a security under the 1940 act b/c the 1940 act looks to regulate the institution itself, not just the product.
  - Under the 1940 Act, short-term paper (which includes notes) is a security. In contrast, the 1934 Act excludes notes from its definition of security.

Companies Not Covered by the Investment Co. Act

- Section 3(a) has a broad definition of what a investment company is.
- Sections 3(b) & (c) have exceptions from the definition
  - There are 4 classifications of the exceptions
    1. holding cos that conduct either directly or through subsidiaries, either non investment company business or conduct business that are excepted from the definition of investment company. E.g. bank holding company
    2. institutions that are subject to alternative regulation. E.g. brokers, pension funds, insurance and banks
    3. Private investment cos, companies whose investors are sophisticated or charitable organizations whose investors are strongly motivated to donate rather than to invest for their own benefit. Eg. Hedge funds, charitable organizations
    4. Unimportant financial institutions when the 1940 act was enacted. Ie. Mortgage banks and industrial banks
- **Holding Cos**
  - Holding Cos issue securities and invest 100% in another company.
  - Under Section 3(a)(1)(c), holding cos are included in the definition of investment cos if they have investment securities exceeding 40% of total assets. In advising a holding co., you would tell them to invest in their subsidiaries. These are securities but not investment securities. Section 3(a)(2) excludes from investment securities, securities issued by majority-owned subsidiaries of the owner.
  - **NOTE:** Section 3(b)(1) does not exempt from 3(a)(1) (a) &(a)(1)(b) b/c if you hold yourself out as a investment company, you will be an investment company.
- **NOTE:** a company w/in 3(b)(1) can decide that it is not an investment company w/o resorting to the SEC. A company w/in 3(b)2) cannot determine its status and must seek and must seek an order from the SEC declaring it not an investment company

NOTE: <u>3(a)(1)(c)</u>, <u>3(a)(2)</u> and <u>3(b)(a)(1)</u> combine to form the asset test. If you do not have 40% of your assets invested in investment securities, you are not an investment company. If you fail the asset test (40% of assets are in investment securities), you can apply to the SEC under 3(b)(a)(2) for an order stating you are not primarily engaged in the business of investing by showing that the income from your investments are used for purposes other than reinvesting. See ICOS.

ICOS Corp.

- ICOS seeks a 3(b)(2) order from SEC excluding it from the definition of investment company.

- ICOS is a biotechnology company that has invested its assets in investment securities but wants an order excluding it from the definition of investment company by finding that it is engaged in a non-investment business. ICOS wants to invest more than 40% of its assets in investment securities but does not wish to be a investment company.
- SEC will look at the use, rather than simply the composition of the company's assets.
- ICOS uses its investment income to fund its research and development program.

Test for Determining Primary Business

1. Company's historical development
2. Company's public representations of policy
3. The activities of its directors and officers
4. The nature of its present assets
5. The source of its present income.

Certain Prima Facie Investment Companies

- Rule 3(a)-1 raises the asset test limitation to 45% - If a company has no more than 45% of its assets and derives no more than 45% of its income from investment securities, it is not primarily a investment company.
- Rule 3(a)-2 is a safe harbor provision providing a 1 year exemption from the 1940 Act for companies starting up or winding down as long as they meet certain requirements.

Special Situation Companies

- When a holding company owns other companies for the purpose of selling the shares of the portfolio company that turn out to be successful, and if the companies public investors expect their profits from these sales, then the companies resemble an investment company. These venture capital companies usually issue their securities via private placements so that they are excluded from the definition of investment company.

Private Investment Companies

- <u>Section 3(c)(1)</u>: none of the following persons is an investment co. Any issuer whose outstanding securities (other than short term paper) are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities
  - <u>3(c)(1)(a)</u>: Ownership by a company shall be deemed to be beneficial ownership by 1 person unless the company owns 10% or more of the outstanding voting securities of the issuer. This means that for purposes of determining whether an investment company is owned by more than 100 persons, under certain circumstances, it may be necessary to look through the entity and count the shareholders of that entity. *However,* this rule only pertains to investment companies. In other words, IBM is considered one person even if it invests 40% or more in a 3(c)(1)(A) company

- **Summary: 3(c) limitations**
    - Less than 100 persons
    - No public offerings
    - Less than 10% ownership by investment companies.
- Suppose the company does not have voting securities? The SEC has held that if 50% of the debt is held by a company, such ownership is control b/c a company can threaten the debtor by calling their loans.

Section 3(c)(7)

New type of private fund that can have unlimited investors meeting certain financial tests. This <u>qualified investor exemption</u>, allows, for example 500 banks to put their money together to invest.

- you can have 99 or less unqualified investors and an unlimited amount of qualified investors.

What if have 3 different funds all managed by the same manager, each has less than 100 investors – are they exempt?

- SEC looks at the economic reality, if all management plans are the same (are clones of each other) then the SEC will integrate the funds into one. Up to the SEC to decide if cloned.
- If each of the funds have different investments ie one invests in MMFs, one equities, one debt – then the SEC will probably not integrate because with different investment come different management styles (even if same manager)

<u>Qualified Investor</u> – 2(a)(51)(a) of the 1940 Act, as (1) any natural person who owns not less than $5 million in investments (2) a family owned company that owns not less than $5 mill in investments (3) certain trusts (4) any other person, eg, an institutional investor that owns and invests on a discretionary basis not less than $25 million in investments.

<u>Rule 2(a)(51)-1</u> defines investments broadly to include securities, real estate, futures contracts, physical commodities, and cash and cash equivalents held for investment purposes.

<u>Lamp Technologies No Action Letter</u>

Internet offering of private securities was a private placement. So a non-public offering can be done through the internet as long as has passwords and pre-qualification procedures.

- Presently the SEC permits internet offerings of private placements if issuers states that it is not open to non-qualified investors and states that it is for private placements.

Banks and Savings and Loan Associations § 3(c)(3)

§ 3(c)(3) – covers a number of institutional intermediaries, including banks and common trust funds, which are vehicles established by banks for investment purposes.

Banks operate common trust funds to manage the assets of trusts and estates to administer more effectively. The pooling of the assets of the individual trusts can reduce investment risk and expenses. Common trust fund, or anything similar maintained by a bank, are exempt from the mutual fund definition. It is exclusively for the investment and reinvestment of monies entrusted to the bank as trustee, executor, administer or guardian.

Banks are currently converting their trust vehicles to investment companies because mutual fund shares are more attractive to investors, the amounts required for investment are smaller, no hand holding as seen in trusts, and the fees are larger.

Financing, Factoring, and Real Estate Companies § 3 (c)(5)
§ 3(c)(5) deals with mortgage bankers that lend money for real estate. They are excluded from investment company definition.

- credit unions are excluded under this subsection

Charitable Corporations § 3(c)(10)
§ 3(c)(10)

- no amounts can be invested for the benefit of any private person
- Whatever is tax exempt is not subject to the securities acts

Pension Plans
The 1940 Act excludes from the definition of an investment company an employee's pension, stock bonus, or profit sharing trust meeting certain IRS Code provisions.

Defined benefit plan – when a person retires the person receives a fixed amount. The investment rewards and risks are borne by the employer

Defined contribution plan – highly paid employees, the company contributes a certain amount into a fund and employee manages fund. As long as didn't withdraw the employee received tax deferral. The investment risk, reward are inured to employee. The investment decisions are left to employee (within limits).

CHAPTER 5
FINANCIAL PRODUCTS OUTSIDE THE 1940 ACT

A. Pools Used to Securitize Financial Assets

Securitization of financial assets involves the establishment of pools to hold assets, and the issuance of securities by the pools.

- Securitization converts illiquid loans into securities banked by these loans
- Also called "asset backed securities"

Pooling

- Bank lends to borrowers and the banks receive the obligation of the borrower to repay (mortgage).
- Bank wants the money today instead in 30 years so banks sell the mortgages to the Pool (SPV). Lenders sell the loans either by securitizing the loans themselves, or by selling loans wholesale to sponsors that would securitize the loans
- The pool is called a single purpose vehicle – SPV – collects many mortgages then issues securities to investors. The investors will receive the payments made on the mortgages.

Legal Issues

- It is important that the transfer is complete between the lender and the SPV because if the lender goes bankrupt, the trustee may claim that loans are lender's assets , not investor's.

Rule 3(a)(7) – an issuer engaged in the business of acquiring and holding eligible assets and who does not issue redeemable securities, is excluded from the Act, not exempted.
Conditions:

- will not issue redeemable securities
- issuer issued fixed income securities (like a bond or IOU, eliminates any other securities)
- the securities issued by the SPV must be rated, no junk bonds allowed
- Buyers must be sophisticated (not for public at large)
- Duty on issuer to make sure sophisticated investor is not just a conduit to the public
- No trading (can't buy more and can't expect capital gains from this portfolio)
- SPV must be run by trustee with no conflicts of interest, not a guarantor, not a provider of credit enhancement.

CHAPTER 6
REGISTRATION AND DISCLOSURE

A. Registration Under the Investment Company Act

§ 8 requires investment companies to register with the SEC, this is in addition to the requirement of the 1933 Act that the securities of the investment company must be registered.

§ 7(d) Foreign investment companies are not allowed to register except by order of the Commission. Foreign companies cannot make private offerings because private investment companies must stay within § 3(c)(1). The reason for this is if foreign companies were allowed to make private offerings they would have no incentive to comply with US law and the US would have no authority to regulate them. Secondly, American companies would move abroad to gain that advantage.

Prospectus and the Statement of Additional Information (SAI)

Duty to disclose is not on the buyer but on the seller, the law allocates the cost of information on the seller. The players:

- a lawyers main objection is to protect the company from lawsuits (want to throw in as much info as possible
- the u/w and the marketing people want to hide the risk and highlight the profit-making abilities
- The SEC is concerned with investor protection and want to highlight the risks.

Liability

- unlimited liability on the issuer
- limited liability on the specialists
- to prove fraud (misstatement) there is no requirement to show intent or causation
- if prove fraud, then receive difference between market price and price paid (only sue when price goes down)
- statute of limitations is one year

Registration of Investment companies
Investment company is an institution, want to know how it will act, what type of financial structure it will have

- Inv Co. Act does not require you to choose what type of structure it will be – can be one person and be an investment company
- only exception, whatever you choose federal law is superimposed on top of it = so corporate law will regulate the structure you decide on and federal law will regulate your actions.

<u>§ 7 Transactions by unregistered investment companies</u>
Must first determine if you are an investment company by looking at § 3, then exceptions under § 3(c)(1) etc.

- If determine that you are an investment company, must look to § 7
- 7(a) prohibition on doing certain transactions if not registered – allowed to organized but once want to sell or deliver securities you must register first.
- So you can create a company designed to do all these things but can't do these things until register.
- SEC must approve registration statement before you sell your shares to investors

Simplification of the Prospectus

- Prospectus written in English for the investor (simple)
- SAI – contains lots of particulars and is only sent to the investor if he asks for it.

<u>White v. Melton</u>

The SAI was incorporated by reference in the prospectus. The shareholder only read the prospectus and sued claiming that the prospectus was misleading.

The Court says that the prospectus was not misleading. It held as a matter of law, you cannot state a claim for fraud under the securities laws based upon the companies placement of information in the SAI as incorporated by reference in the prospectus, rather than in the prospectus itself.

- somewhat analogous to ignorance of the law is no excuse
- The burden is on the investor to ask for the SAI

NOTE
Need more than questions and answers in the prospectus with reference to the SAI – not enough information.

<u>Improving Risk Disclosure</u>

A fund is required to discuss in its prospectus the principal risk factors associated with investing in the fund.

- the SEC is concerned that funds are only providing very general information on the risk level of the fund.
- The SEC wants disclosure requirements to be revised to improve the communication of fund risk to the investors and increase the likelihood that the investors will comprehend the risk of a particular fund before they decide to invest.

Electronic Delivery of Disclosure

The SEC believes that delivery of information through an electronic medium generally could satisfy delivery or transmission obligations under the federal securities laws.

- Electronic delivery is permissible if the electronic delivery provides substantially equivalent information as would the paper form
- There should be an opportunity to obtain a permanent record of the info (download)
- Can electronically deliver prospectus updates

Prospectus Updates

Tabankin v Kemper Short-Term Global Income Fund
The plaintiff says the mutual fund advertised itself as a conservative investment, which would use a "prudent" investment strategy. The plaintiff's continue by arguing that managers pursued a risky course of investment which caused plaintiff losses.

Failure to disclose material information in supplemental literature if that information is disclosed in the prospectus. In this case, the brochures contained disclosures about risk and referred the readers to the prospectus. The prospectus made it cleat that the fund's net asset value would fluctuate and listed specific risks, therefore there was no material missrepresentation.

To prove fraud, the missrepresentation must be material – to be material the statement must significantly alter the total mix of information available to the investor.

In re Hyperion Securities Litigation
Plaintiffs claim that (1) the Trusts' investment strategy was missrepresented and (2) the risks were not disclosed during the Trusts' roadshows.

The court ruled that even though the brokers in the roadshows didn't mention all the risks, the prospectus bristled with warnings and a reasonable investor would have read it before investing.

CHAPTER 7
FUND MANAGEMENT: THE ADVISORY FUNCTION, FEES AND CONTRACT TERMS.

Contractual Arrangements (advisory contracts)

- the investment adviser can only serve with a written contract
- the contract must precisely describe the compensation to be paid (but places no limits on compensation)
- Shareholders must approve the advisory contracts
    - But shareholder's don't really choose their advisor.
    - Shareholder's vote for directors, who in turn select an advisor – hard to get rid of an adviser because everything (entire management 60% with adviser) goes with him if fired and all management functions are in the adviser, therefore if terminated the shareholders suffer real losses.

External Fund

BOARD Contract regulated by statute (§ 15(a), 36(b))
Officers
Contract
FUND ($) management services (ADVISOR)

SHAREHOLDERS (elect's board's directors)

Because the board will consist of members affiliated with the adviser, the board must consist of 40% independent directors.

- the promoters of the fund are also the advisor.
- The board oversees Advisers management functions
- In mutual funds, unlike other entities, allows for board members to be part of the adviser. Unlike corporations, advisers can provide services like u/w and broker dealers for many different funds, but each fund will have different management.

Supervision
Two levels before issues reach SEC

(1) the board oversees the adviser
(2) the adviser oversees its employees and management decisions

However the board has no independent firing and hiring ability over the adviser. This is unique to MFs because, in contrast, a corporate board can fire corporate management.

The board's power comes from being partially independent. Only the board and the shareholders can form new advisory contracts, set new advisory fees and select new advisers.

Investment advisers to an investment contract must have a written contract. If shareholders fail to renew an advisory contract, there is no adviser – problems. Therefore, this never happens, if shareholder doesn't like management, it will redeem its shares and go elsewhere.

- Because an advisor's fees are generally based on total assets, he has the incentive to keep shareholders invested.

Internal Funds

This is where the fund hires the adviser so he is an employee rather than an independent contractor. Therefore, the board maintains the power to hire and fire him, section 15 does not apply.

Example – Vanguard is the second largest fund company and is internally managed. Vanguard does this because has primarily index funds which seek to reflect the market by using computers to carry out the functions of portfolio managers. This cuts cost because the price of management is reduced (saves on costs).

<u>Fees</u>

How do you decide if the fees charged by the adviser are too high?

- most investors do no calculate advisory fees into their investment decisions, as a result they are not aware when they are excessively charged.
- Furthermore, advisers do not compete on the price of their services.
- There is no correlation between quality of service and price of service
- The standard rate that advisors charge is .5% of assets.

When the price "shocks the conscience" it is too high, however there has never been a case where fees have shocked the conscience.

- this is because many of the companies agree to reduce their fees before the case goes to judgement

Advisers have developed a system of declining percentages as assets increase beyond certain break points. For example, charge .5% of assets under $500mill, then charge .425% of assets from $500 m - $1bill, and then charge .375% of assets in excess of $1 bill.

- this is because the more money invested, the more the costs are spread out. The costs/expenses increase less compared to the increase in assets – there is an increase in costs, but not at the same rate, therefore don't need the full .5% fee.

<u>Krinsk v Fund Asset Management Incorporated</u>

Plaintiff alleged a breach of fiduciary duty and that the fees paid by the fund were excessive. A

§ 36(b) of the Inv. Co. Act permits shareholders to sue on behalf of the corporation (fund) when the adviser breaches their fiduciary duty by receiving excess fees. However, there are a lot of limitations to these suits:

- one year statute of limitation

- limited damages
- protection against the advisor from losing his registration.
- This is different than § 9 whose damages permit loss of registration
- Can also sue trustees and directors under 35(b)

The court here said that to violate 36(b) the adviser manager must charge a fee that is *so disproportionately large that is bears no reasonable relationship to the services rendered*. The following factors are considered:

(a) the nature and quality of services provided
(b) the profitability of the fund to the adviser manager
(c) fall out benefits
(d) economies of scale
(e) comparative fee structures
(f) independence and conscientiousness of the trustees

The court rules that all of these factors are in favor of the adviser.

<u>Advisory Contract § 15</u>

§ 15 provides that it shall be unlawful for any person to serve or act as an investment adviser of registered investment company except pursuant to a written contract. Furthermore, it is unlawful for the investment company to enter into, renew or perform a contract or agreement unless the majority of the independent members of the board of directors of the investment company approve the contract.

- Advisory contracts cannot be assigned because they are fiduciary relationships which entitle the investor to rely on the particular adviser. If assigned the contract is terminated.

The assignment of an advisory contract is permissible subject to two provisions:

- the assignment must be approved by a board consisting of 75% of independent directors
- for two years after the assignment, the investment company cannot suffer undue burden.

NOTE
Advisers are allowed to sell shares of themselves to another adviser. Why?

- Because the system works with very large advisers and will not merge over this one thing.
- When applied to small advisers, the statute requires that upon merger or sale all of the old adviser's old employees must remain

Competitor's cannot sue under 1940 Act – intended for investor protection only.

CHAPTER 8
CORPORATE GOVERNANCE:
FUND DIRECTORS AND SHAREHOLDER VOTING

Investment companies can take any legal form their sponsors choose for them: partnerships, limited partnerships, business trusts and corporations.

Popular Forms of Organization

- many open end investment companies are organized as business trusts – associations that are established under a declaration of trust. The legal title to the assets of the trust are held by a trustee while the beneficial interest is divided into transferable units or shares.
- Business trusts differ from corporations in that the trustee is the legal owner of the trust property

Relationship between State Law and the Investment company Act

Burks v Lasker

Shareholder derivative suit brought against interested directors. The disinterested directors dismiss the suit.

Issue – is the state power of independent directors circumvented by federal statute (1940 act)

Held – federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with federal statutes.

- look to federal law if there is a governing provision, express or implied. If not then go look at state law
- Here, federal law was silent on the issue.

Frankel disagrees with this opinion on one point – congress did not conscientiously grant directors the ability to decide conflict of interest problems, Congress gave this power to the SEC, not directors.

Sections of the Investment Company Act that Regulate Corporate Structure

§ 2(a)19 – status disqualification –cannot be considered an independent director. There are 5 categories of status disqualified persons

- This defines interested directors and includes the 2(a)(3) person (the affiliated person of the investment company)
- IT includes any interested person of the investment adviser or principal u/w of the investment company
- Includes affiliates of the investment adviser and the immediate family of the affiliate
- includes investment advisers, principal u/w of investment companies

- includes any person determined by the SEC to have a "material business professional "relationship within the past two years with the investment company or a principal executive officer of such company or another investment company in the same fund complex
- can't have been legal counsel, left, then come back and be considered a disinterested director

§ 17 – transaction disqualification – these also establish circumstances where conflicts of interest prevent a party from being classified as a disinterested director
- there are 25 categories of transaction disqualifications because it includes affiliates of affiliates

§ 2(a)(3) – defines affiliated persons

§ 2(a)(9) – defines control

John Nuveen (no action letter)

Issue – does the 1940 Act require annual shareholder meeting (when state law doesn't)?

§ 16(a) – requires election (a meeting of shareholders) under only two circumstances:
- to elect the initial board of directors
- to elect directors to fill existing vacancies on the board in the event that less than a majority of directors were elected by shareholders.

This no action letter is similar to Burt v Lasker because both are narrow readings of federal law which allow for application of state law. Federal law must explicitly apply to the situation at hand.

Composition of the Board § 10(a)

10(a) requires that a registered investment company's board of directors may not consist of more than 60% interested persons (40% disinterested).

Strovco v Scudder

Plaintiff says that the board wasn't disinterested because board members were sitting on multiple boards within the same fund family. The plaintiff wanted to file a derivative suit and demand was futile because board was interested.

Held – there must be a sufficient number of directors on a board that do not serve on other boards – in this case one of seven did not serve on multiple boards and that wasn't sufficient – held for plaintiff. Case doesn't say this explicitly, but under Maryland Corporate law it would seem that would need at least two members to be disintereste.

Frankel says this judge didn't know what he was talking about. Today, between 7 – 8,000 MFs, so if need 3 independent directors would need 21,000 people. The case has put a question mark on the number of boards a director can sit on and raises concern that there would not be a sufficient number of directors. It very hard to regulate this issue because it is so individualized (based on an individual financial position) and that is why the SEC has left it alone.

After this case, Maryland amended its corporate law to look like § 2 of Act – as long as not barred by a status conflict, can serve on board as a disinterested director.

<u>The Role of the Board</u>

§ 15(c) states which questions the Board members must ask the adviser.

What Board members must ask:

- must ask all information to enable it to evaluate the contract terms between the adviser and investment company

What Board members should ask (under duty of care obligations § 36)

- what are the problems with the business – investigate red flags, for example why did directors leave in the past, any scandals going on
- ask about risks that company facing and others in the industry face
- insurance
- conflicts of interest
- soft dollars

<u>Shareholder Voting</u>

Under the Investment Company Act shareholder voting is require to, among other things, elect board members, implement changes to a funds investment policy and to approve fees. When a fund is required to solicit votes of shareholders, a proxy is used. Proxies governed by Federal Securities laws (1934 Act).

<u>Valuation</u>

2 kinds:

- <u>Market price</u> – liquid
- Unregistered shares – its <u>fair value</u> is determined in good faith by or under the direction of the fund's board. Rule 22(c)(1) requires that purchases and redemptions of redeemable shares be effected at current net asset value per share that is computed after the receipt after the receipt of the purchase redemption request.u
    - One danger is when the portfolio manager prices the value himself, this results in performance results which are not materialized in the market. This problem comes to a head when portfolio manager wants to sell and the price is lower than he had anticipated the market to be – as a result the board must assure that the pricing is in the hands of independent pricing agents.

CHAPTER 10
THE INVESTMENT COMPANY AS INVESTOR

Generally, the Act does not regulate investments. The Act simply requires disclosure of the investment policy that the investment company will follow and limits changes in this investment policy. Section 12 limits investments in broker dealers, underwriters, investment advisers, insurance companies, and other investment companies.

A. Restrictions on Investments of Investment Companies – Section 12
   1. Investments in B-Ds, underwriters and Advisers
      - Section 12(d)(3) prohibits investment companies and companies that are controlled by investment companies from purchasing or acquiring any securities issued by or any other interest in the business of any broker, dealer, underwriter or investment adviser. This prohibition applies to both affiliated and unaffiliated entities.
      - Why these limitations?
         - Prevent investment companies from dumping shares
         - Prevent conflicts of interest. The Act is concerned that investment companies will siphon good shares out for their own benefit.
         - Regulate control that investment companies exercise over these companies. Don't want investment companies to control substantial part of a company.
      - Does 12(d)(3) permit investment companies to buy put options from broker-dealers? Is a put option a security issued by a broker? Puts and options are included in definition of securities ergo put options in broker-dealers prohibited.

   2. Disclosure Requirements
      - Section 35 says that 80% of the stock owned by the fund must conform to the name of the fund
      - Sections 8 & 12 require disclosure of fundamental policy in the prospectus or in the SAI
      - Unlike Corporate law, the doctrine of ultra vires is still alive in this area. The investmet company must adhere to its statement of fundamental policy
   3. Fund of Fund Limitation
      - there is a fear that if 1 fund invests in another fnd which offers redeemable securities, the first fund will threaten to redeem the securities unless the acquired fund will invest as the acquiror sees fit.
      - A mutual fund cannot buy over 10% of a investment fund's voting stock and a mutual fund cannot invest more than 5% of its assets in one investment company.
      - These limitations promote diversification and prevent double fees charged to the small investor.

   4. T.Rowe Price Release (p.295) – Rule 12(b)(1) allows for a mutual fund to pay for the distribution of its shares. This allows for the manager to take some of the investor's funds and pay underwriters or broker dealers

5. **NOTE:** Affiliated Funds are allowed to invest in each other b/c view is that the common adviser has an interest in each of the affiliated funds. Furthermore, SEC has authority to invest in unaffiliated funds.
   - Requirements for such investments:
     - No double fees
     - Independent board members on each side

6. How are wrap fees different from fund of funds?
   - Wrap fees: individual relationship between adviser and investor. Investor can terminate at any time. Very personalized. Governed by Rule 3a-4
   - Funds of Funds: impersonal relationship. Little control exercised by investor. Mass produced.

7. Liquidity:
   - Not expressly required by statute. However, because advisers are scared, guidelines (not requirments) state that 85% of investments be liquid.
   - Open end mutual funds must stand ready to redeem shares daily and pay redeeming shareholders w/in 7 days of receiving a redemption requiest.(Section 22(e))
   - An illiquid asset is an asset which may not be sold or disposed of in the ordinary course of business w/in 7 days at approximately the value at which the mutual fund has valued the investment on its books.

8. Diversification:
   - Section 5(B)(1): A mutual fund calling itself diversified must invest a certain amt of its assets in securities of various issuers. The fund's assets are divided into 2 blocks
     1. 75% of its assets must consist of cash and cash items, govt securities, securities of other investment companies and other securities. A fund may not include in this basket the securities of a single issuer accounting for more than 5% of the funds assets or constituting more than 10% of the issuer's voting securities
     2. 25% basket has no restrictions on it.

B. Effecting Trades – Restrictions on Relationship w/ Broker-dealers and Underwriters. Sections 10, 17(e)
   - Section 10(b) prohibits a registered investment company from employing as regular brokers or using as a principal underwriter any of its directors, officers, or employees, or any person of which any such directors, officers, or employees is an affiliated person, unless a majority of the board of directors of the company consists of persons, who are not such brokers or principal underwriters or their affiliates.
     - This clearly precludes members of the securities industry form controlling investment companies.
   - Rule 10(f): prohibits investment companies from knowingly purchasing securities during the existence of an underwriting or selling syndicate if an officer, director, member of the advisory board, the adviser, or the employee of the company is a principal underwriter of the company.

  - No investment company may buy or sell 4% of its assets from any underwriter if the principal underwriter is involved in the distribution. This is because underwriters consist of a small group and it is feared that backscratching relationships would develop.
  - 10(f) is engineered to prevent members of the securities industry from controlling investment companies and also to prevent underwriters from dumping stocks on funds.

- See policy arguments behind diversification and prohibitions on investment companies involvement in corporate governance. (p. 303)

- Should the board consider social as well as economic factors when making investment decisions? (p. 312) Tobacco Case

D. Custody of Investment Company Assets (Section 17(f))

1. Regulation of Custodians

- investment companies are legally required to put their client's funds in safe custody, and sometimes segregate client's funds from the adviser's own funds and earmark them.
- 17(f) designates the qualifications of a custodian.
  - the trustee or custodian should be a bank which has an aggregate capital, surplus and undivided profits of not less than $500,000.
- 17(g) requires that employees who have access to investment company funds should be covered by a fidelity bond.
  - Rule 17g– 1(d) requires that a majority of the disinterested directors approve the fidelity bond at least once a year and the bond must be reasonable
- 17(j) Personnel Investment Activities of Investment Company Personnel
  - 17(j): makes it unlawful for persons affiliated with a rule 17j-1 organization (a fund or its investment adviser or its principal investment adviser, in conection with the purchase or sale of securities held or to be acquired by the fund, to engage in any fraudulent, deceptive or manipulative acts.
  - The SEC has authority to adopt codes of ethics for such purposes.
  - **NOTE:** The rules require that these institutions adopt a code of ethics and place restrictions on the timing and nature of these person's personnel transactions.

2. Ronald v. Speaker

- portfolio manager breached his fiduciary duty to the fund by taking the investment opportunity in the debentures without disclosing the opportunity to, and obtaning the prior consent of the fund.

CHAPTER 12
PROTECTION AGAINST CONFLICTS OF INTEREST

1. The Investment Company Act

- the 1940 Act does not vest in the disinterested directors the authority to approve conflicts of interest transactions between a defined group of insiders and the investment company (or a company controlled by the investment company)
    - the SEC serves the watchdog role here (in conflict of interest transactions)

a. the exception of Section 15 which authorizes disinterested directors and a majority of the shareholders to approve the advisory and underwriting Ks, most of the conflict of interest transactions are prohibited altogether, exempt by specific provisions subject to conditions, or allowed upon an exemption from the SEC.

b. **Section 17a**: People who may not engage in conflict of interest transactions are defined in 17a which applies to not only affiliates but affiliates of affiliates (25 groups altogether)

- <u>Section 17(a)</u> prohibits transactions in which one party is an investment company, or a company controlled by the investment company and at least one of the other parties is (1) an affiliate person of the investment company, or an affiliate of the affiliate, (2) a principal underwriter for the investment company or an affiliate of the underwriter, or (3) a promoter of the investment company or an affiliate of the promoter.
- The degree of affiliation is measured from the investment company, not the controlled company.

- Section 2(a)(3) defines affiliates.

- Some affiliations go only 1 way, meaning that you are my affiliate but I am not your affiliate.
    - E.g. a director is an affiliate of an investment company but a investment company is not an affiliate of a director. The same thing applies to partners.
    - If you are a 5% shareholder, affiliation goes both ways
    - An adviser is an affiliate of an investment company but not vice versa
    - If 2 investment companies are under common control, they are both affiliates of each other.
- Section 2(a)(9) defines control broadly in that it does not necessarily require legal control. You look to actual control
    - Examples:
        1. A owns 5% of voting shares of the Investment Co. The IC owns 5% of B. A and B want to do a deal. The 5% rule goes both ways so A & B are affiliates. This is OK b/c they are not principals and 2 affiliates can interact.
        2. Suppose B is controlled by the IC. You look to actual control. A and B can't interact b/c

3. A owns 5% of the IC. B owns 5% of IC. C owns 5% of B and is considered an affiliate of an affiliate. Can A and C transact? Yes, as long as there is no control involved.
4. Director of IC sold property to B who is a 5% affiliate of IC. This is OK b/c the IC is not involved, therefore no principals are involved. If B is controlled by investment company, then the deal is forbidden
5. IC owns 5% in IBM and IBM has a subsidiary. The transaction between the IC and the sub of IBM is not allowed b/c the transaction is one between the IC and a affiliate of an affiliate.
6. IC has shares of IBM and MCI. MCI and IBM can deal b/c the transaction between two affiliates is allowed. **NOTE:** The IC may get shares in an exchange but there is an exemption for that

17b requires that parties seeking an exemption must do so before the deal goes through.

1. **Vanguard Municipal Bond Fund**
   - Vanguard has 7 different portfolios, all with the same adviser. Vanguard wants to use cash from one portfolio and invest it into a money market fund which is another portfolio.
   - Vanguard concedes that the different portfolios are affiliates b/c they are under common control.
   - Vanguard needed an exception from Sections 17 and 12(b)(1). SEC granted the exemption on condition that certain fees are eliminated and the adviser did not receive a benefit. Vanguard wants to do this despite the loss of fees b/c there is an advantage to keeping the money in house.
2. **Sierega & Co**.
   - the adviser of a fund trades too much (maybe b/c of softdollars)
   - the money under management is shrinking. In his K with the MF, there is a limit to the amt of expenses which is 1% of quarterly net assets.
   - The adviser ran 2% expenses which violated the K. Adviser can't amend the K b/c it needs directors/officers/shareholder approval
   - The SEC says the extra expenses paid were an actual borrowing of the fund which was prohibited by 17(a)(3) (äffiliates can't borrow)

<u>Conflicts of interest in joint transactions 17(d)</u>

<u>17(d)</u> is an open ended transaction where the investment company and its controlled company are on one side of the transaction with a third party and the affiliates and their affiliate's are on the same side as the third party.

- to exempt from prohibited conflict of interest the SEC must find that the terms of the transaction for the investment company are unequal to those of the affiliate.
- If the affiliate does something to bring in the fund on the same terms as another fund would get it is ok. The prohibition is that it cannot bring in an affiliate fund in on unequal terms (can't give this affiliate a benefit).
- The equality test (17d) is tougher than the fairness test in 17b.

SEC v Talley Industries

Talley is an affiliate of the AI Fund because the AIF owns 9% of Talley. Talley sought to acquire General Times. Talley called AIF and told them to purchase shares of General Times also. Because a Mutual Fund and its affiliate are on the same side of a transaction, they should have applied for approval of the deal before it went through under Rule 17(d)-1.

- 17(d) it is unlawful for any affiliated person of a registered investment company to effect any transaction in which such registered company, or company controlled by such registered company, is a joint or joint and several participant, with such person in controvention of such Rules as the SEC may promulgate.
- In the case Rule 17d-1 requires the parties to ask for an exemption

What if directors purchase shares for themselves on the same day that the fund purchases shares?

- 17(j)(1) prohibits fund managers from purchasing shares or selling shares within certain time of the fund's transactions.
- The SEC has also said this would constitute a 10(b)(5) violation because would be insider trading.

Conflict of Interest in Agency Transactions 17(e)

17(e)(1) – it shall be unlawful for any affiliated person of a registered investment company, acting as an agent, to accept from any source any compensation for the purchase of any property for such registered investment company.

US v Deutsch

Mills is an employee of Fidelity and officer of Fund. Fidelity advises the Fund. Mills bought securities from Deutsch at a 50% discount which Mills then sold to Fund at market price.

- This is a violation of his fiduciary duties to the fund because was seized the fund's corporate opportunity.
- This also violated 17(e) which prevents kickbacks and self-dealing
- An offense under 17e(1) is complete when the compensation is delivered and received with the forbidden intent.
- The objective of 17e(1) is to prevent affiliated persons from having their judgement and fidelity impaired by conflicts of interest.
- In order to be a kickback to an agent it required that Mills be someone who could bind the agency through his conduct. Which means that he was able to force the Fund to buy the shares that he had just bought at a discount.

Affiliated persons acting as an agent of the company cannot accept compensation from the purchase or sale of securities. And with the purchase or sale "securities" is the key language because don't have to prove that he was influenced or took any action due to the conflict.

Exceptions to Rule 17(e)(1)

1. Brokers can take commissions if usual (standard) under 17(e)(2) in connection with the purchase or sale of property.
2. Underwriters can always take commissions, no “usual” language.

Conflicts of Interest by Underwriters § 10(f)

§ 10(f)(3) – prohibits an investment company from purchasing securities during an underwriting or selling syndicate, if any of the company’s directors and officers is also a member of the syndicate.

- this is to prevent underwriters from dumping their securities on investment companies
- this prohibition extends to purchasers to any member of the u/w selling syndicate or even if that member is not an affiliate with the investment company.

Merrill Lynch Asset Management

ML owns ML Asset Management which owns H& W. SEC says that MLAM is not a barrier between ML and H&W because is a fully owned subsidiary, therefore ML and H&W are affiliates.

- H&W is a specialist, a subadviser, which specializes in a particular sector of industry.
- A fund will hire subadvisers to oversee a portion of the fund.

17(e)(2)(a) prevents ML from acting as broker to any fund that H&W services if it will receive a higher than usual commission.

- ML becomes an affiliate of an affiliate of all the funds that H”&W services

10(f) – prohibits a registered investment company from knowingly purchasing or acquiring any security during an underwriting syndicate if a principal underwriter is affiliated with the investment company.

- in this case all purchases of securities by H&W from a syndicate from which ML is the principled underwriter fall with the provisions of 10(f)

Because H&W has this problem under 10(f), all other subadvisers will have the same problem.

SEC grants relief provided ML must show fairness – show that H&W’s clients are not under ML’s control, because they are not protected by 17 because these guys are independent. ML provides assurances of fairness of the decision makers.

CHAPTER 11
DISTRIBUTION OF INVESTMENT COMPANY SHARES

A. Regulation of Sales Loads: Different methods of Paying for Distribution

Sales charge or sales load is a percentage of the public offering price of the shares – covered sales and promotional expenses associated with the offering.

No-load fund – the investor is not charged a sales load, to qualify for such the cost to the customer must be less than 2%

Deferred Sales Load – "contingent deferred sales load" CDSL – the investor pays fee when he redeems his shares but the amount investor pays decreases the longer he keeps his money in the fund. For example, if redeems at end of 1 year, he pays 90%…redeems after 5 years pays nothing.

- in this situation, the adviser pays the broker dealer up front (broker dealer usually charges 8.5%)
- The adviser fits the bill for the offering fees because he the percentage of fees he gets from advising the fund is greater than the percentage paid to the broker dealer – the larger the fund the more fees.

In 1980, advisers convinced the SEC that the fund should pay the broker dealer. So now the fund pays the adviser who in turn pays the broker dealer.

12(b)-1 Plan – is a combination of a CDSL and a distribution plan. (fund paying expenses over time) As a substitute for charging investors a front-end sales load, the fund's principal underwriter initially pays the sales and promotional expenses associated with the sale of fund shares, including any commissions paid to persons that sell the shares. The principal u/w then recovers the amount expended through payments under the fund's 12(b)-1 plan – which provides that annual payments for distribution may not exceed a specified percentage of the fund's average net assets (ceiling).

Exemptions Needed when doing plans

§ 2(a)(3) – redeemable security – need exemption because customer will not be receiving pro rata share because deducting distribution costs – ok because it is only a deferral of what customer should have paid earlier.

§ 2(a)(35) – defines the term "sales load" to be an amount properly chargeable to sales or promotional expenses that is paid at the time the securities are purchased. Need an exemption because CDSL's are charged after they are purchased, not at the time – SEC said was ok.

§ 22(c) – requires that the price of a redeemable security be based on the fund's current net asset value. A CDSL results in the investor received less than current NAV.

§ 22(d) – requires a mutual fund, its principal underwriter and any dealer in redeemable securities issued by a fund to sell securities only at a current public offering price described in the fund's prospectus. This provision requires that all investors be charged the same sales load – this is outdated because the CDSL's sales loads vary according to the amount of time the investor remains in the fund.

Proposed Rule 6c-10 – permits use of deferred sales load provided certain conditions met – this rule is still on the books.

National Association of Securities Dealers

NASD regulates broker dealers – is an SRO. They want to subject asset based sales to a maximum sales charge. NASD has to get their rules approved by the SEC. The SEC found that the NASD properly exercises its authority.

Rule – maximum sales charge is 8.5% (6.5% if certain benefits not performed) of the share price.

Maximum asset-based sales charge is .075% of average net assets.
Maximum service fee is .025% of average net assets.

These limits are needed because disclosure is not enough because can hide competitive discounts.

B. Retail Price Maintenance

§ 22(d) – investors must be charged a fixed price stated in the prospectus. This provision prohibits a registered investment company and such principal u/w of a or a dealer in its redeemable securities from selling such securities to any person except a a current public offering price described in the prospectus. Underwrites and brokers who participate in the distribution can receive a commission but may not sell the securities at a discount from the fixed price. Among themselves, brokers can divide the commissions (this eliminates a secondary market in these redeemable securities).

Proposed Rule 22d-6
- this is intended to give investment companies maximum flexibility in pricing their shares
- Companies may permit negotiation of sales load at time of purchase subject to certain conditions but not at time of redemption.

C. Buying Mutual Shares on Margin

Rule 11d1-2 – exempts any security issued by an open-end management company or unit investment trust registered under the 1940 Act from certain credit restriction of the Exchange act provided that the security has been owned for more than 30 days by the security holder.

- permits broker dealers to extend credit to a customer on fully paid securities issued by open end management investment companies or UITs if the customer purchases the securities held as collateral more than 30 days prior to the extension of credit.
- So customer can use his mutual fund shares, as long as has held them for longer than 30 days, as credit to purchase other securities.

D. Exchanging Investment Company Shares

Rule 11a-3 – Rule would allow mutual funds to exchange shares with an investor from another fund from the same family of funds. This is called “switching” – the practice of inducing security holders of one investment company to exchange their securities for those of a different investment company solely for the purpose of exacting additional sales loads.

- family of investment companies is defined as any two or more registered open end investment companies having the same investment adviser or principled underwriter and holding themselves out to investors as related companies.
- The investor can be charged a sales load and an nominal administrator fee, however the sales cannot be greater than the sales load he would have paid on his original shares – prevents advisers from charging additional sales loads.

CHAPTER 13
MONEY MARKET FUNDS

MMF has two important aspects:

1. dollar pricing – investors invest one dollar and get one dollar back plus interest (low risk because invest in US securities – treasury bills, short term commercial paper and bank notes – short term investments)
2. issuing checks – MMFs allow savings and instant redemption.

Pricing of shares – use the NAV formula = assets – liabilities divided by shares outstanding

How to maintain a stable NAV is determined by interest rates and economic situation of the issuer of the paper.

Rule 2a-7 regulates MMFs. Can ignore deviations of NAV up to .005% as long as real market value of assets remain at one dollar. Requirements for this:

- short term maturity (can't have maturity greater than 13 months and weighted average can't be greater than 90 days)
- dollar dominated portfolio – avoids currency risk – can invest in a foreign issuer who issues debt in american dollar.
- liquid portfolio – cannot invest more then 10% of assets in illiquid securities. A security is liquid if it can be sold at the price the fund is holding it at within 7 days.
- portfolio quality – issuers must be high quality, eligible security (has to be rated in top two tiers at time of purchase – if security falls out of top two tiers cannot roll it over upon duration).
    - The money market does not need to dump commercial paper when it drops below 1st tier but must bring down position to 1%. If commercial paper falls below 2nd tier, the adviser must sell as soon as practical unless board decides that not a good idea – the paper cannot be rolled over.
- minimum credit risk – diversified portfolio, cannot invest more than 5% of its assets in any one security (measured at time buy security)

<u>CHAPTER 14</u>
<u>UNIT INVESTMENT TRUSTS</u>

How Do You Establish a UIT?

A promoter / depositor gives a trustee / custodian at least a $100,000. Depositors assemble a portfolio of securities which they deposit with trustee and receive from the trustee units representing a pro rata share in the portfolios. The depositor is the promoter. He receives these pro rata shares from trustee and sells these shares to the public. The trustees hold title to the assets and are responsible to the administrative duties (trustees are usually banks).

- Evaluators value the UITs portfolio for purpose of establishing redemption and secondary market prices of the UITs shares (what is sold to public).

UITs are often used by u/w s and brokers to get rid of bonds that they are stuck with. The broker takes the bonds then adds other securities to make a diversified portfolio which it transfers to the trustee in return for unit shares.

Why do investors choose UITs?

- There are no advisory fees, however there are broker, distribution and evaluator fees.

The distribution of the securities

Trustees sell units of the trust rather than trust securities. The units are sold for net asset value plus commission, in other words it is a static price.

Characteristics

- UITs must be registered under § 7(b) of the 1940 Act. § 8(b) establishes the registration requirements.
- UITs don't have a board of directors and have a fixed portfolio rather than managed portfolios. This means that UITs are not a management company under § 4.
- Invest mainly in debt securities like bonds and corporate equity like preferred stock.
- UITs must issue redeemable securities.

Orphan UITs

- when the trustee and the depositors abandon the trusts and leave the investors stuck with their shares
- § 26(a)3 prevents a trustee or custodian from resigning until either the trust has been completely liquidated or a successor has been appointed.

Substitution of UIT assets

Can only substitute assets that are similar to ones already in trust. Must get SEC approval to do this.

Affiliated Transactions

§ 17 would prohibit a transaction between UITs and their sponsors (or principal u/w). *However*, while 17(a)(1) prohibits affiliated persons of an investment company from knowingly selling any security or other property to the company, section 17(a)(1)(c) excepts such a transaction from the provisions of section 17 if the sale involves only securities deposited by sponsors w/ trustees of UITs. Because UITs have only fixed portfolios and rarely purchase securities or sell securities after they are organized, section 17(a)(1)(c) makes the prohibition of 17(a) largely inapplicable to all but occasional elimination or substitution in which UIT depositas are involved as buyers or sellers (but not as redeemers of UITs Trusts).

Minimum Size of UITs

Section 14(a)(2) exempts from the minimum capaital requirement investment cos that have a net worth of at least 100K at the time they made a public offering. This applies to UITs when the UIT is organized in a series form. If one series qualifies under 14(a)(2), subsequent series can rely on this.

Rule 14a-3 protects investors by requiring distribution of a UITs assets if the UIT's net worth falls below 100K within 90 days after the effective registration statement. Furthermore, if the sponsors or underwriters effect redemption of unsold units and reduce the UITs net worth of less than 40% of the principal amt of the securities initially deposited in the trust, the sponsor must terminate the UIT and distribute its assets and the sales charges.

Switching of UIT Units

Under Section 11(c), the exchange of UIT securities for the securities of any other investment company's securities is prohibited unless the SEC gives permission. It is generally prohibited b/c such exchanges deplete the trusts and cause excessive sales load payments to the investors.

Dividend Distributions

Section 19 and Rule 19b-1 regulated disclosure and frequency of investment company's distribution of dividends and long term capital gains.
Rule 19b-1 makes an exception for UITs which obtain dividends from regulated investment companies. These trusts may receive distributions from various portfolio securities more frequently than once a year. The rule permits the UIT in certain circumstances to distribute in a reasonable time after receipt to their own shareholders the payments they had obtained on the portfolio securities.

CHAPTER 15-
CLOSED END INVESTMENT COS

Closed end investment cos are management cos, namely, investment companies other than UITs and face-amount certificate companies.
Closed end cos do not issue redeemable securities and therefore do not distribute their securities to the public continuously. They instead, have offerings periodically.
Underwriters for closed end companies are treated as a regular underwriter, not a underwriter for an investment company.

Why does redeemability matter?
Closed End Cos have shares that are always traded, not redeemed.
- As an adviser, you want closed end b/c even if the fund does poorly, investors cannot redeem. Only the management, at their discretion, can repurchase the shares.
The 1940 Act does not regulate closed-end companies distribution, advertising, or the pricing of their securities, as it does with open-end investment companies.

Shares Closed-End Investment Cos sell at a discount
There is always a discount from the initial offering price in the secondary market for these shares. The reasoning is that the market believes that the managers take too much (through conflicts of interest etc) or work to the detriment of the fund. Others believe that there is a future risk that people will look unfavorably at funds and further discount the fnd.

Proposed Solutions
Interval Funds: Rule 23c-3 allows for a closed end/open end mix. This basically allows close end investors the opportunity to sell periodically at net asset value (e.g. above the market price). Not more often than once every 2 years.

- **NOTE:** this is different than redemption because the decision to repurchase shares is vested in the board of directors, therefore the shares are not redeemable pursuant to Section 2(a)(32). The repurchase decisions is made by the companies' managers, not the investors.
- The ability to sell shares to the fund reduces the discount on the market b/c there is increased liquidity. If investors know they will be able to tender their shares to the fund at NAV, shareholders will not fear losses due to deeper discounts, demand for the funds' shares would increase and share prices would rise.

In addition, funds can make periodic repurchase option, every 3, 6 or 12 months. The fund must also give notification in advance of these actions. These standard time frames were imposed by the SEC so that investors could distinguish these funds from open-end funds.

SPDRS

This is an investment Co. that reflects as closely as possible the shares representing the index of the S&P 500. The purpose of which is to allow investors to play the market w/ a single investment.

SPDRS shares are offered in very large denominations called Creation units. Creation units are given to investment bankers in exchange for securities that buyers offer to the companies. The holders of creation units break them down into shares of smaller denominations and distribute these shares.

A SPDR is a hybrid of a closed end and open end investment company. The Creation units are redeemable in kind, at NAV. The small denomination shares are, however, not redeemable and resemble in this respect shares of a closed end investment company, and are traded in secondary markets. Their price need not reflect the NAV of the investment companies portfolio. The secondary market however, trades at close to NAV because investors know the following:

- Because the small denominations are not redeemable, large investors can recreate the creation units by buying the small denominations back. The creation unit can then be redeemed in kind at NAV(get the original securities back). The original securities can then be sold at a profit. This is likely to happen the larger the difference between market price and NAV. The large investors will buy the smaller denominations when they begin to sell for less than NAV b/c this presents an opportunity for arbitrage. The large investor (ie. Merril Lynch) can buy back the shares at market value and redeem them at the higher NAV.

Conversion into Open-End Funds

Many close end sponsors hold out the possibility of converting to open end status at some future date. The SEC seeks to ensure that investors receive clear disclosure concerning under what conditions will a close end company become a open end company.

CHAPTER 16
VARIABLE INSURANCE PRODUCTS

Main features of variable products:

1) combination of insurance and investment companies
2) issue obligations and invest in obligations
3) retains insurance risk – person either lives too long or dies too early (as a result premiums remain)
4) substitute diversification, expertise of analyst's for investor's risk – traditionally investors received a fixed return from interest and under variable annuities investor's return or lack of return correlates to the securities they own.
    - the essence of the difference between fixed and variable annuities is that variable annuities are linked to the value of investment company shares managed by the insurance company for the contract holder's benefit and at their risk
    - so the investment risk is borne by the annuitant, not the insurance company (as in fixed income annuities)

Three transfers of variable insurance products:
1) transfer the investment decision to the investor
2) transfer the return from the investment to the investor
3) transfer the investment risk to the investor.

Once investor retires, starts to receive payments of variable amounts. When investor dies, the amount, if any, remaining invested remains with the insurance company.

Variable annuities are considered both insurance and securities. Here, during the pay in period it is security because the annuitant pays installments to the insurance company which it invests in securities. Insurance company pools money and invests it into securities (like MF). Each annuitant gets units based on how much invested and the value of their units corresponds to the value of the securities underlying the fund.

In the pay out period an insurance feature is involved. No contract holder has a claim for his propionate share of the reserves – which means he may receive more or less than he paid in. If he dies early does not have claim for rest of principle paid.

SEC v Variable Annuity Life Insurance of America

Tried to make a variable annuity into insurance by guaranteeing a 2% floor to annuity payments during the pay out period. This was the company still would bear some risk. SEC said no real risk transfer to company because can get a 2% return on government securities and had no other fund separate from the account that would guarantee payments. Therefore SEC said it was a variable annuity.

If not a investment company (product is not like a security) then would be an insurance company which are exempted from the investment company act.

CHAPTER 18
ETHICAL ISSUES

Rule 2(e) – the SEC may bar a lawyer from appearing before it or preparing documents for it. The rule is based on the SEC's necessity of trust for the attorney who speaks before it. If an attorney lies it can prohibit that attorney from ever appearing before it.

Carter and Johnson were two Brown and Wood lawyers who were barred by the SEC when they failed to report the misdoings of the CEO quickly enough.

Kaye Sholer example – government said law firm was an aider and abettor because the law firm was silent when the client talked to the government agency and lied (and lawyers knew he was lying).

Options for lawyer when client violates rules

- say to client don't do it
- if client refuses and continues to act wrongly then lawyer must
    - go to board
    - resign
    - go to the SEC