

**Mutual funds**  
**Professor Frankel**  
**Final Exam**  
**December 16, 2008**  
**9 a.m. to 4 p.m.**

This is a take-home examination. Please return your answers to the Registrar's office no later than 4 p.m., December 16, 2008.

**1. The question**

The assignment described in this examination raises a number of legal issues. Please uncover and discuss the issues, and offer an analysis and solutions. The story is replete with issues, some of which we covered in class and some of which we did not. It is very unlikely that you will uncover and discuss all issues. The reason for the many possible issues in the assignment is to offer you more choices to demonstrate what you have learned.

**2. The grading**

The grade of your answers is influenced by the (1) number of issues that you discussed; (2) the quality of the answers and analysis, including the authorities that are cited; and (3) your suggestions to overcome legal problems or ambiguities that the clients' objectives might raise.

Please note that your grades are not determined by comparing your answers to optimal answers, but rather by comparing your answers with those of the other members of the class.

**3. Sources, added facts, cite-forms, and length of answers**

You may use and rely on any source-material you choose. However, please clearly note in a footnote or in the text between brackets (e.g., [-]) whatever material you use and cite. The form of your citation does not affect the grade of the exam, so long as the source could be found by anyone else. In addition, if, in your opinion, a relevant fact is missing from the story, please state that you assume a particular fact, and continue your discussion based on the assumed fact.

**4. Length of the answer and its organization**

Your answer may not exceed 10000 typed words or 15 hand written pages (double space). I will not read any materials beyond the limits. In addition, the organization and clarity of your answers are valued. Therefore, before starting to write, read the question carefully, conduct your research, and outline your answers. Then, start writing.

I am looking forward to reading your answers.

## **The Examination Question**

You are an associate in the Boston law firm of Able & Bentley (A&B), founded in 1851. A&B's senior partner and head of the 1940 Acts department, is John Clements (CL). Recently, CL became outside counsel to a small hedge (Hedge Fund) fund and venture capital fund (Venture Capital). The adviser to these two funds is "Your Advisers" (YADV). YADV is considering adding a mutual fund to their Hedge Fund and Venture Capital. The purpose of this addition is to open YADV successful Hedge Fund to a broader group of investors. CL asks you to assist in the matter. Recently, the two of you met with the two principals of the YADV: David and Ellen. CL, your boss, asks you to prepare a memo addressing the issues raised at your meeting with David and Ellen and taking into consideration the materials noted below.

Please focus on the legal requirements of the Investment Company Act of 1940 Act and the Advisers Act of 1940. However, you should also consider what must be changed in the clients' the current structure and arrangements of YADV and its affiliates if the client is to operate both a hedge fund and a mirror image mutual fund, provided this business plan is feasible.

### **2. The facts**

#### **A. YADV and Its Business**

YADV is organized as a Limited Liability Company (LLC). YADV is a small, Boston-based investment adviser, managing nearly \$1 billion in assets. The assets are managed in (1) six separate accounts, (2) one hedge fund—Hedge Fund and (3) six venture capital funds Venture Capital. The firm was founded in the late 1990s by David and Ellen. YADV has several minority members/partners, but David and Ellen are the majority owners.

Ellen's activities focus on the firm's hedge fund (Hedge Fund). She moved to Boston in the 1990s after attending Boston University and Stanford. Her family made a large fortune in the early days of Silicon Valley. This fortune forms the core of the assets invested in Hedge Fund.

Like Ellen, David was raised in the San Francisco Bay Area, where he attended Santa Clara University, starring on their basketball team, before migrating to Boston to attend Harvard Business School. David and Ellen met at Harvard and promptly built a strong bond of professional friendship. David's role is the oversight and management of YADV's Venture Capital funds.

David and Ellen cut their teeth in the hedge fund and venture capital businesses at various Boston money management firms before collaborating to form YADV in 1998. Since the firm has fewer than 15 investors and makes no advertising or attempts to market its services to the

public, it has never registered under the Advisers Act. In addition, neither Ellen nor David is registered as advisers.

**B. The Hedge Fund LLC**

As noted, Ellen manages Hedge Fund. The investors in Hedge Fund satisfy the “qualified purchaser” and other requirements of § 3(c)(7) of the Investment Company Act of 1940. Hedge Fund currently has about 90 investors, most of whom are employees of YADV and/or relatives and friends of Ellen and David. Hedge Fund has approximately \$200 million in invested capital. It uses a high degree of leverage as part of its investment strategy, and consequently, has currently a total portfolio of investments of about \$800 million.

Hedge Fund’s objective is high performance. Stock selection has tended to be eclectic, based mostly on Ellen’s assessment of the relative prospects of industries and market segments. Hedge Fund makes net purchases of some issuer’s stock while simultaneously selling short the securities of other issuers. This strategy by Hedge Fund to hedge involves investment risks. For example, the fund may buy Exxon common shares while selling short Chevron common shares. In such a strategy, the Fund would profit if Exxon delivers superior performance relative to Chevron regardless of whether the market for oil companies goes up or down. Hedge Fund’s securities and related derivatives portfolio is far larger than the \$200 million in invested capital because Hedge Fund, using margin, borrows significant amounts of money in executing its investment strategy. Currently, Hedge Fund controls nominal securities and derivatives positions exceeding \$800 million.

In addition to its role as sponsor and manager of Hedge Fund, YADV is a significant investor in Hedge Fund through YADC’s fully owned subsidiary, Management, which also serves as the general partner of Hedge Fund. YADV and Management together receive the following fees from Hedge Fund:

- A management fee of 2% per annum of assets under management, plus
- A 20% allocation of profits (based on trading profits and capital gains), if any.

The performance fee allocation is triggered when profits of Hedge Fund exceed a portfolio return of 5% based on average invested capital over Hedge Fund’s fiscal year (which happens to be, like all funds managed by YADV, on a calendar year basis) and net of all Hedge Fund expenses.

Hedge Fund has a tremendous track record, up over 340% in the last five years. Ellen was concerned about the U.S.’s debt run-up over the past few years. Therefore, she positioned Hedge Fund to win in an inflationary, disrupted economic environment in the U.S. Recently, Ellen focused on energy and oil companies, commodities producers, and mining companies. Competitors and friends have loudly encouraged her to start a mutual fund based on her success and investment style. In addition, a number of clients have asked for a fund that can accept smaller investors; hence, Ellen’s interest in starting a mutual fund.

**C. The Venture Funds**

David is responsible for the firm's Venture Funds, which have been issued in several series--a new series one every couple of years. To date, Venture Funds' capital is \$120 million. Each series has between 8-15 investors. All investors are institutions or high net worth investors who've been qualified as § 3(c)(7) investors for Investment Company Act of 1940 purposes.

All Venture Funds invest in small, young companies. Most companies are involved in life sciences or high-technology concepts or businesses. Many are start-ups with no operating experience. Some are just good ideas with a management team to promote them. Wally formed an advisory board of key science experts to help him evaluate investment opportunities. A company that makes the grade is marked: !VentureFunds@! David has gone so far as to trademark the term.

The Venture Funds' portfolio companies follow the typical path of start-ups: many fail, some enjoy modest success before being acquired or liquidated, and some are like Google or Microsoft. From time to time, a portfolio company engages in an Initial Public Offering (IPO) of its shares, which provides a nice return to the particular relevant Venture Fund. Interestingly, Hedge Fund has invested in several of these companies after their IPO. Ellen only invests in those situations where she's been able to follow the companies' development and prospects to make sure that they meet her investment criteria for Hedge Fund.

Venture Funds have done well. Venture Fund series of 1998 has already returned to its investors \$50 million (on an original committed and invested capital of \$20 million). The venture capital business is directly impacted by the current economic disruptions. As a result, David noted that it was likely that raising capital for a new series should be deferred until the economic mood has improved.

**D. Ellen's Desire for a Mutual Fund**

As noted, Ellen has become quite excited about creating a mutual fund of her own. She would like to model it after the Hedge Fund as closely as possible. At your meeting with her, she expressed concern that mutual funds cannot leverage the way hedge funds can and asked you to validate that. She also asked you to outline any other major differences and conflicts she would experience between managing the hedge fund and a mutual fund.

**E. Proposed Trustees for Mutual Fund**

One item that CL, the partner at A&B noted was important to address quickly in the evolution of the new mutual fund. This was the composition and qualifications of a proposed board of trustees for Mutual Fund. Ellen has forwarded the following list of potential candidates for the five board positions. CL has asked you to examine these persons in terms of their status

as “interested” or “disinterested” trustees.

- Phoenix R. Ising: Phoenix Ising lives in Tucson, AZ where he operates a construction company building retirement colonies for aging baby boomers. He’s Ellen’s brother.
- William Jurek: Willie Jurek is the long-serving chief executive officer of Top Quality Services Co. which is based in Santa Barbara, CA. Willie is one of the largest operators of laundromats in the country. A classmate of Ellen and of David at Harvard, Willie constantly is buying and selling laundries. Recently, however, the credit freeze crisis has been disastrous for his business since he’s been unable to get financing for deals. He even needed to borrow \$1 million from Ellen, via the Hedge Fund, temporarily to finance a deal. All was done at arm’s-length with Willie’s firm paying 8% interest for the loan.
- Victor Almaviva: Vick Almaviva is the senior portfolio manager of the Patriot Fund LLC, a New York based hedge fund. He is a former classmate of Ellen at Stanford and they often share investment ideas. Indeed, on occasion their funds have collaborated on proxy battles with the management of certain companies to influence their business strategies. Such activist investing has proven profitable for both Ellen and Vick.
- Sigmund Favel: Ziggy Favel is a professor of financial economics at Pamplona Institute of Technology in Southern California. Favel provides economic consulting services on a routine basis to Hedge Fund. As is the case for many professors who consult, consulting income constitutes a significant portion of his yearly income.
- Maria Ramirez: Maria Ramirez is the chief financial officer of an operating public company in the technology field, Networks2. Maria is married to Ellen’s second cousin and lives in Los Altos, CA.
- Hildegard Pakoff: Hilde Pakoff lives on Cape Cod and is a former partner in the public company audit group of the now defunct public accounting firm of Arthur Anderson. After Anderson folded in 2002, she joined Grant Thornton and, until her retirement in 2005, Hilde audited the books of the Hedge Fund and Venture Funds. Grant Thornton is proposed to serve as the independent accountants for the new Mutual Fund.
- Gary Merry: Gary Merry is a consultant on executive compensation matters. He has never professionally advised Hedge Fund or any of its personnel on such issues. He lives in Newton, MA and is a tennis partner of David.

- Henri Duplo: Henri Duplo is a retired money manager living in Northampton, MA. Many years ago he was a partner of Almaviva, but their partnership as money managers ended over twenty years ago. He also owns 10% of Hedge Fund voting securities.
- Scott Adamms: Scott Adamms is David's step-father and lives in San Francisco, CA where he works as an illustrator. He is quite naïve about investing, but has gained some notoriety and success with a comic strip about his stepson.
- Faneula Faust: Fanny Faust is an attorney who retired from the practice of law five years ago. She had been A&B's law practice head in the area of pension benefits and ERISA law. She lives in Hanover, NH where she enjoys pottery and skiing.

**F. Your Assignment**

As noted above, CL has asked you to prepare a memo addressing the issues raised at your meeting with Ellen and David, and the additional information you received. Please focus on the legal requirements of the Investment Company Act of 1940 Act and the Advisers Act of 1940. Although several specific questions were raised in the discussions, you should address any related issues of significance under these Acts. In particular, you should also consider what must be changed in the current structure and arrangements of Hedge Fund and its affiliates to operate both a hedge fund and a mirror image mutual fund, and if this is feasible.

In addition, you know that CL likes to publish articles from time to time. Therefore, you might note public policy issues that arise from your research. Describe these policies in not more than two paragraphs, for his attention.