

Mutual Fund Regulatory Overview

Key Mutual Fund Regulations

- Shares of mutual funds must be priced and be redeemable on a daily basis at their current net asset value per share (Rule 22c-1 under the Investment Company Act of 1940 (the "1940 Act")).
- Redemption payments must be made within seven days, and the right of redemption can be suspended only in limited circumstances, such as when the New York Stock Exchange is closed (other than customary weekend and holiday closings or when trading on that exchange is restricted) (Section 22(e) of the 1940 Act).
- Offering materials must be supplemented or amended at least annually and more frequently if necessary to keep disclosures current and accurate.
- Mutual funds are limited in their use of leverage and may only borrow from banks (subject to a 300 percent asset coverage requirement on the amount of such borrowings).
- Mutual funds may not invest more than 15 percent of their net assets (10 percent in the case of money market funds) in illiquid securities (i.e., securities for which market quotations are not readily available, restricted securities and other investments that generally cannot be sold within seven days at approximately the price at which they are carried by the fund).
- An investor qualification requirement will apply if a mutual fund pays performance-based compensation to its investment adviser (other than a "fulcrum"-type performance fee under which the fee increases and decreases ratably based on the performance of the fund in relation to the performance of a designated index) or subadviser. Generally, this qualification requirement would require limiting investors to persons having a net worth of more than \$2 million (Section 205 of the Investment Advisers Act of 1940 (the "Advisers Act")).

Investment-Related Regulations

- *Diversification.* Mutual funds must declare themselves to be diversified or nondiversified.
 - Generally, a diversified fund is required to invest more than 75 percent of the value of its total assets in cash and cash items (including receivables), government securities, securities of other registered investment companies, and other securities that are limited with respect to any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the fund and not more than 10 percent of the outstanding voting securities of the issuer (Section 5(b) of the 1940 Act).
 - A nondiversified mutual fund is not subject to this requirement, but will be subject to a similar diversification requirement with respect to 50 percent of its assets under the qualification requirements of Subchapter M of the Internal Revenue Code.
- *Concentration of Investments.* Mutual funds must have a policy on concentration of investments within any industry group (Section 8(b) of the 1940 Act).

- A mutual fund that intends to invest more than 25 percent of the value of its assets in the securities of issuers engaged in any one industry must disclose that policy and must at all times concentrate its investment in that industry, except under specifically defined circumstances (e.g., defensive investment positioning during periods of adverse market conditions).
- A mutual fund that does not declare a policy of concentrating its investments may not invest more than 25 percent of the value of its assets in the securities of issuers engaged in any one industry.
- Mutual funds typically use industry classification codes published in the SEC's Directory of Companies Filing Annual Reports to determine the industry in which an issuer is engaged. An industry sector (e.g., biotech or energy) is not considered to be a single industry. Thus, it typically is not necessary for a mutual fund to declare a policy of concentrating its investments.
- *Investment in Other Investment Companies.* Mutual fund investments in other registered investment companies are limited (Section 12(d)(1) of the 1940 Act).
 - Generally, a mutual fund may not (i) purchase more than 3 percent of the outstanding voting stock of another investment company; (ii) purchase securities issued by another registered investment company representing more than 5 percent of the investing mutual fund's total assets; and (iii) purchase securities issued by investment companies that in the aggregate represent more than 10 percent of the mutual fund's total assets.
 - Most exchange traded funds (ETFs) have obtained SEC exemptive orders under which investments in those ETFs by mutual funds (subject to certain conditions) will not be subject to these limitations. In addition, investments in shares of money market funds are not subject to the limitations if certain conditions are met (Rule 12d1-I under the 1940 Act).
- *Investment in Securities-Related Issuers.* A mutual fund may not purchase any securities of an issuer that is a broker or dealer, is engaged in the business of underwriting or is a registered investment adviser, except in accordance with certain limitations (Section 12(d)(3) of the 1940 Act; Rule 12d3-I under the 1940 Act).
 - An investment is permitted if, as a result of the purchase, the mutual fund (i) will not own more than 5 percent of the outstanding securities of that class of the issuer's equity securities; and (ii) will not own more than 10 percent of the outstanding principal amount of the issuer's debt securities, provided that after the purchase the mutual fund will not have invested more than 5 percent of its assets in securities of that issuer.
 - Such an investment generally is not permitted if the issuer is affiliated with the mutual fund or if the security being purchased is a general partnership interest.
 - An issuer is deemed to be engaged in the securities-related businesses described above if in its most recent fiscal year it derived more than 15 percent of its gross revenues from securities-related activities (unless the mutual fund will control the issuer after the acquisition).
- *Investment in Insurance Companies.* Generally, a mutual fund may not purchase more than 10 percent of the outstanding voting stock of an insurance company unless at the time of purchase it

owns more than 25 percent of such securities (Section 12(d)(2) of the 1940 Act).

- *Use of Leverage.* As noted above, the use of leverage by mutual funds is restricted by the 1940 Act and by various interpretations of the SEC staff (Section 18(f) of the 1940 Act).
 - A mutual fund may not issue debt. It may, however, borrow money from a bank. Any such borrowings are subject to a 300 percent asset coverage requirement. (This means that a fund may borrow amounts that do not exceed 50 percent of its assets, excluding the amounts borrowed.)
 - Derivatives and other transactions/positions under which a mutual fund may be liable to a third party in an amount exceeding the amount of the fund's investment are prohibited unless the fund has segregated (or "covered") on its books (or on the books of its custodian) liquid assets having a value equal to the amount of the fund's potential obligations (marked to market daily).
 - These restrictions may limit a mutual fund's ability to engage in certain types of investment strategies, particularly those that require significant leverage. However, it may be possible to create a similar investment exposure within the applicable constraints by using swaps and other derivative investments.

Important Fund Governance Requirements

- *Composition of Fund Boards.* As a practical matter (because of conditions that apply to funds that rely on various exemptive rules under the 1940 Act), a majority of the members of a mutual fund board must be independent directors (Rule 0-1 under the 1940 Act).
 - Generally, persons who are not affiliated with and do not own any securities of the fund's investment adviser (or any affiliated person of the adviser) will not be "interested persons" and, therefore, will qualify as independent directors (Section 2(a)(19) of the 1940 Act).
- *Board Approval of Advisory Agreements and Principal Underwriting Agreements.* A mutual fund's investment advisory agreement and its agreement with any principal underwriter (i.e., the firm that serves as the distributor of the fund's shares) must be approved by the fund's board and by a majority of the fund's independent directors. Advisory agreements must also be approved by a majority of the fund's outstanding voting securities (which at inception could be the vote or consent of the adviser who holds the initial seed capital shares) (Section 15 of the 1940 Act).
 - Advisory agreements and principal underwriting agreements may only have initial terms of up to two years and may continue from year to year thereafter only if approved by a majority of the independent directors.
 - Advisory agreements may be terminated by a mutual fund board (including the independent directors), without penalty, at any time on not less than 60 days' notice.
 - Subadvisory agreements are treated the same as advisory agreements under the 1940 Act. However, the SEC has granted exemptive relief to many funds, allowing them to engage subadvisers without obtaining shareholder approval.

- *Audit Committee and Approval of Accountants.* A mutual fund must have an audit committee of its board of directors.
 - The audit committee is required annually to approve the retention of the mutual fund's independent accountants.
 - The selection of a mutual fund's independent accountant must also be approved annually by the fund's independent directors (Section 32(a) of the 1940 Act).
 - Audit committees typically meet at least twice each year.
- *Other Board Responsibilities.* Mutual fund boards and independent directors have a wide range of other responsibilities imposed by rules adopted under the 1940 Act and must approve various other matters relating to a fund's operations.
 - The board has general oversight responsibilities with respect to the operations of a fund and the services provided to the fund by its adviser and other service providers.
 - Fund boards typically meet on a quarterly basis. Although participation in such meetings by telephone is generally permissible, independent directors must vote "in person" when approving advisory agreements, principal underwriting agreements and accountants.

Selected Reporting Requirements

- Semiannual and audited annual financial statements must be mailed to fund shareholders not later than 60 days after the end of the applicable fiscal period. These financial statements are filed with the SEC on Form N-CSR and are public filings. They include schedules of investments showing all of a fund's investment positions, including short sales.
 - Form N-Q, showing a mutual fund's portfolio holdings, must be filed with the SEC not later than 60 days after the end of the first and third fiscal quarters. These filings are public.
 - Form N-CSR and Form N-Q filings must be certified by the principal executive officer of a mutual fund and the principal financial officer of the fund.
 - Mutual funds must file Form N-SAR with the SEC after the end of their semiannual and annual fiscal periods. This form contains data regarding a fund and its operations.

Distribution of Fund Shares

- Mutual fund shares may be sold with or without sales charges. Rule 22d-1 under the 1940 Act permits discounts in (or elimination of) sales charges if applied on a uniform basis to all investors in a class of shares.
- Sales charges may be front-end loads paid by an investor at the time shares are purchased, or may be contingent deferred sales loads, which the investor pays if shares are redeemed before they have been held for a specified period. (Generally, the applicable contingent deferred sales load declines each year over the specified period.)
- A mutual fund may have different classes of its shares, each having different fees and expenses

based on differences in distribution and shareholder services (Rule 18f-3 under the 1940 Act).

- A mutual fund may pay distribution-related fees/expenses, provided such payments are made pursuant to a 12b-1 plan adopted by the board. A fund's 12b-1 fees cannot exceed 100 basis points and, along with sales loads, are subject to various other FINRA limitations.
- Mutual funds can generally advertise offerings of their shares. However, SEC and FINRA rules govern the content of mutual fund advertising. These rules require, among other things, that performance information used in advertising (and in sales materials accompanied by a prospectus) include (or in some cases, be limited to) certain standardized performance information.

Prohibition on Affiliated Transactions

- An affiliated person of a mutual fund (and affiliated persons of such persons) is generally prohibited from selling securities or other property to, or buying securities or other property from, the fund. Thus, a mutual fund cannot engage in principal transactions in securities with affiliated persons (Section 17(a) of the 1940 Act).
- An affiliated person of a mutual fund generally cannot borrow money from the fund (Section 17(a) of the 1940 Act).
- An affiliated person cannot receive any compensation for acting as agent of a mutual fund in connection with the purchase or sale of any property. However, an affiliated person may receive usual and customary compensation (specified by the 1940 Act and Rule 17e-1 thereunder) for acting as a broker for a mutual fund. Thus, a mutual fund may use an affiliated broker for agency transactions in securities and pay commissions on those transactions (Section 17(e) of the 1940 Act).
- An affiliated person of a mutual fund (and affiliated persons of such persons) is generally prohibited from participating in or effecting any transaction in connection with any joint enterprise or joint arrangement in which the mutual fund is a participant (Section 17(d) of the 1940 Act and Rule 17d-1).
- A mutual fund may not purchase securities being underwritten by an affiliated person during the course of the underwriting, except in accordance with certain conditions (Section 10(f) of the 1940 Act; Rule 10f-3).

Compliance and SEC Examinations

- *Compliance Program.* Mutual funds must (i) adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws; and (ii) designate a chief compliance officer (CCO) to administer these policies and procedures. (The fund CCO may also serve as CCO of the fund's adviser.)
 - The CCO (with respect to his/her role with the mutual fund) reports directly to the fund's board of directors and may not be removed from service to the fund except by board action.
 - The compensation of the CCO must be approved by the mutual fund's board.

- The CCO is required to review and provide a written report, not less frequently than annually, regarding the operation of the mutual fund's compliance program.
- *SEC Examinations.* The SEC and its staff have the authority to conduct periodic and special examinations of the required books and records of mutual funds.
 - Examinations generally focus on the overall compliance controls in place, but also focus on a variety of specific areas relating to fund operations and compliance with applicable regulatory requirements.
 - After an examination, the staff normally issues a deficiency letter noting any items it would like addressed.
 - The SEC staff also may conduct "for cause" examinations.

Other Rules and Regulations

- Rules adopted under the USA Patriot Act require mutual funds to implement anti-money laundering programs, including customer identification procedures.
- Mutual funds are subject to rules adopted under the Gramm-Leach-Bliley Act, which require the adoption of a consumer privacy policy and that notice of the policy be provided to investors.
- Mutual funds must maintain fidelity bonds providing coverage in specified amounts to protect against "larceny and embezzlement" by officers and employees who may have access to fund assets (Rule 17g-1 under the 1940 Act).
- A mutual fund's securities and other assets generally must be held in custody by a U.S. bank (Section 17(f) of the 1940 Act). Rules adopted under the 1940 Act permit the use of foreign subcustodians and domestic and foreign securities depositories, subject to certain conditions (Rules 17f-4, 17f-5 and 17f-7 under the 1940 Act).
- A mutual fund must adopt a written code of ethics and institute procedures governing personal trading in securities by officers, directors and other personnel (Rule 17j-1 under the 1940 Act). These codes are similar to those required under the Advisers Act and require initial and annual holdings reports and quarterly transaction reports.
- Mutual funds are required to maintain, and to preserve for specified periods, various books and records (Rules 31a-1 and 31a-2 under the 1940 Act).
- Persons who have been convicted of certain crimes within the past 10 years, or who have ever been subject to certain securities- or commodities-related court-imposed injunctions, are ineligible to serve as an employee, officer, director, investment adviser or principal underwriter of a mutual fund (Section 9(a) of the 1940 Act).

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