

## **OVERVIEW OF FEDERAL AND STATE REGULATION OF INVESTMENT COMPANIES**

### **I. BACKGROUND**

#### **A. Principal Regulatory Statutes Applicable to Investment Companies**

Mutual funds are governed by a regulatory scheme that includes the federal securities laws, state securities and corporate laws, federal and state tax laws, regulations enacted by self-regulatory organizations, and rules established by the Securities and Exchange Commission (“SEC”) and the Internal Revenue Service (“IRS”). Specifically, the organization and operation of mutual funds are affected by each of the following:

##### **1. Securities Act of 1933 (“1933 Act”)**

The 1933 Act governs the registration of securities and establishes civil liability for false or misleading registration statements.

##### **2. Securities Exchange Act of 1934 (“1934 Act”)**

The 1934 Act regulates the securities exchanges and the over-the-counter markets, securities broker-dealers, and transfer and clearing agents.

##### **3. Investment Company Act of 1940 (“1940 Act”)**

The 1940 Act regulates open- and closed-end investment companies, as well as their investment advisers and principal underwriters.

##### **4. Investment Advisers Act of 1940 (“Advisers Act”)**

The Advisers Act regulates investment advisers.

##### **5. State Corporate Laws**

State corporate and business trust laws govern the organization and powers of corporations and business trusts and also define certain shareholder rights, responsibilities and duties of directors, and other obligations to shareholders.

##### **6. State Securities Laws**

State securities laws are primarily concerned with the registration of securities, broker-dealers, and smaller investment advisers.

**7. Internal Revenue Code of 1986 (“Internal Revenue Code”)**

The Internal Revenue Code governs the tax treatment of registered investment companies and their distributions to shareholders.

**8. Employee Retirement Income Security Act of 1974 (“ERISA”)**

ERISA establishes principles of fiduciary conduct and responsibility applicable to persons dealing with a retirement plan or other employee benefit plan.

**9. Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley Act”)**

The Sarbanes-Oxley Act imposes additional corporate disclosure and financial reporting requirements by creating an oversight board for the accounting profession, mandating measures to promote auditor independence, adding disclosure requirements for investment companies and other public companies, and strengthening criminal penalties for securities fraud.

**10. Other Federal Laws**

There are a number of other federal laws affecting registered fund operations, including the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (“USA PATRIOT Act”), the Electronic Signatures in Global and National Commerce Act (“E-SIGN”) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

**B. Structure of a Mutual Fund Complex**

**1. Members of a Fund Complex**

Mutual funds usually contract with certain agents and organizations to provide services. In most instances, these organizations provide services to all mutual funds within a complex. This externalization of management is the most striking feature of the industry’s organizational pattern.

Typically, although one company can perform more than one function, these external agents include:

- a) Administrator -- The company employed by the fund to be responsible for its corporate functions and to supervise other service providers.
- b) Adviser -- The company employed by the fund to provide investment advice and portfolio management.

- c) Distributor -- The company employed by the fund to sell its shares.
- d) Transfer Agent -- The company employed by the fund to maintain shareholder records and provide service to shareholders.
- e) Custodian -- The company employed by the fund for safekeeping of securities, cash and other assets of the fund.
- f) Independent Accountants -- Review books and records, advise management on accounting issues, and issue reports on audits to fund boards, shareholders, and the SEC.
- g) Lawyers -- Advise fund management, fund directors, and affiliates on compliance with the complex regulatory requirements associated with the organization and operation of funds and development of new products.

## 2. **Role of Members of the Complex**

- a) The Administrator
  - (1) The administrator is often the organizer or sponsor (or an affiliate of the organizer or sponsor) of the fund. In that capacity, it will provide or arrange for the documentation for the registration of the fund and its public offering of shares.
  - (2) As sponsor, the administrator may have established a new investment concept or means of distribution that warrants starting the new fund.
  - (3) In many organizations, the administrator provides a variety of other services. These additional services may include:
    - (a) Portfolio pricing services;
    - (b) Accounting services, including computation of net asset value; and
    - (c) Corporate services.
  - (4) The business relationship between the fund and administrator is extremely close.
    - (a) There are usually common officers and may be common directors. (Disinterested directors must

separately approve advisory and principal underwriting contracts and any distribution plans.)

- (b) There is a common or similar name in many cases.
- (5) With the use of outside vendors, the working relationship among the various organizations is critical. The fund will usually rely on the administrator to:
  - (a) Monitor performance of the custodian and transfer agent; and
  - (b) Be responsible for oversight of fund operations.

b) The Adviser

The adviser's role is to provide professional investment advice to the fund. The adviser is responsible for pursuing the fund's investment objectives.

- (1) The same company frequently serves as administrator and adviser.
- (2) The adviser has a contractual relationship with the fund which establishes specific functions to be performed and the compensation to be paid.
- (3) Advisers are closely regulated by the SEC.
  - (a) Investment Company Act of 1940
    - (i) The 1940 Act provides for the approval of advisory contracts by the fund's directors and shareholders.
    - (ii) The 1940 Act regulates other terms of advisory contracts.
    - (iii) The 1940 Act governs certain of the adviser's transactions with the fund.
  - (b) Investment Advisers Act of 1940
    - (i) The Advisers Act requires the registration of fund advisers and requires certain disclosures regarding the adviser's background and business practices.

- (ii) The Advisers Act requires that certain books and records be maintained.
- (iii) The Advisers Act regulates the terms of advisory contracts and structure of advisory fees.

c) The Distributor

- (1) A fund may offer its shares to the public in a variety of ways. Some funds offer their shares directly and do not employ a broker-dealer to sell or distribute them. The vast majority of funds have formal distributor relationships.
- (2) A distributor usually has an exclusive contractual relationship with the fund to sell its shares. It may act as principal for or as agent of the fund. It in turn may sell through brokers and through its own direct sales organization, or market directly to the public.
- (3) Distributors are often affiliated with the fund adviser, but they need not be and, in some cases, are prohibited from being affiliated.
- (4) Contracts with distributors are regulated under the 1940 Act, which requires the approval of the distribution agreement by the fund's directors and shareholders and governs the approval by directors and shareholders of any plan of distribution pursuant to Rule 12b-1 under the 1940 Act.
- (5) Distributors must register and comply with regulations under the 1934 Act. Distributors must comply with the 1933 Act in connection with the offer and sale of fund shares. Distributors are also regulated by FINRA. States require distributors to register as broker-dealers.

d) The Transfer Agent

- (1) Principal functions performed by a transfer agent include:
  - (a) Processing purchases and redemptions of capital shares and dividend transactions;

- (b) Maintaining all shareholder information, including name, address and taxpayer identification number, and transferring ownership of shares;
  - (c) Processing shareholder correspondence and calls; and
  - (d) Filing dividend and distribution notices with the IRS.
- (2) Transfer agents must register and are regulated under Section 17A of the 1934 Act. However, the responsibilities of a fund transfer agent are primarily established contractually by its agreement with the fund.
- e) The Custodian
- (1) The traditional role of a custodian is the safekeeping of securities, cash and other assets of the fund. In this capacity, the custodian (usually a bank) performs only limited functions as agent of the fund and has no discretion. Typically, the custodian:
- (a) Settles portfolio purchases and sales;
  - (b) Identifies and collects portfolio income (interest on bonds and dividends on stock);
  - (c) Makes and reports cash transactions;
  - (d) Provides safekeeping of securities, including interfacing with centralized depositories (such as the Depository Trust Company); and
  - (e) Monitors corporate actions and capital changes.
- (2) The custodian often also performs “portfolio accounting” functions including:
- (a) Maintaining general ledger accounts;
  - (b) Pricing portfolio holdings;
  - (c) Calculating the net asset value per share; and
  - (d) Accumulating financial information for management, regulatory and shareholder reporting.

- (3) Custodians typically establish a relationship with another custodian (usually another bank) to perform custodial functions in foreign countries.
- (4) The relationship between custodian and adviser is critical due to the need for a daily interchange of information. This information includes the following:
  - (a) Cash balances available for investment; and
  - (b) Trade data necessary for the custodian to perform its portfolio accounting functions.
- (5) Custodians are regulated directly and indirectly by the SEC, the Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and/or various state banking commissions.

## II. **SECURITIES ACT OF 1933**

### A. **Purpose of the Act**

The “Truth in Securities Act” was enacted “to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof . . . .” In order to effect this purpose, the 1933 Act requires registration of securities with the SEC and detailed disclosure to the SEC and to prospective shareholders of matters relating to the issuer, the securities, and pertinent regulatory matters.

### B. **Statutory Framework**

The 1933 Act regulates all types of securities and transactions, except those which are specifically exempted. If the 1933 Act applies, no “offer” of securities may be made unless the issuer has filed a registration statement covering those securities; and no sale or delivery of those securities may be made unless the registration statement has been declared effective by the SEC and a “[s]ection 10(a) prospectus” (“statutory prospectus”) has been delivered to the purchaser.

#### 1. **Exempt Securities**

Section 3 of the 1933 Act exempts the following securities from the requirements of the Act:

- a) Securities issued or guaranteed by the United States or any state or territory of the United States, and any of their instrumentalities.

- b) Short-term commercial paper, which is generally defined to mean obligations with a maturity at the time of issuance of no more than nine months.
- c) Securities issued by banks, building and loan associations, savings and loan associations, and similar institutions.
- d) Securities offered only “intrastate.”

## 2. Exempt Transactions

Section 4 of the 1933 Act exempts the following transactions from the requirements of the Act:

- a) Transactions by any person other than an issuer, underwriter, or dealer.
- b) Transactions by an issuer not involving any “public offering.”
- c) Transactions by a dealer after the expiration of 90 days from the effective date, or 40 days in the case of a company which has previously sold registered shares.
- d) Unsolicited ordinary brokers’ transactions.

## C. Regulation of Communications as Offerings

When an issuer decides to make a public offering of securities required to be registered under the 1933 Act, the Act strictly regulates the contents and use of all written and broadcast communications that contain an express or implicit offer to sell those securities.

1. Prior to registration, no written or broadcast offers and no sales may be made.
2. After registration but before the effective date of the registration statement, no sales may be made and only three types of written or broadcast offers to potential investors may be made:
  - a) “Red herring prospectuses,” i.e., copies of the proposed prospectus which have been clearly labeled to warn the reader that the disclosure is subject to revision and the security cannot be sold until the registration statement is effective; and
  - b) “Omitting prospectus” advertisements under 1933 Act Rule 482, with similar legends.

3. After the effective date of the registration statement, sales may be made, provided that a copy of the statutory prospectus is delivered to each purchaser. Supplementary sales materials may also be distributed.

## **D. Civil Liabilities**

### **1. False or Misleading Registration Statements**

The 1933 Act provides a specific civil remedy for purchasers of securities offered by means of a materially false or misleading registration statement. A registration statement is false or misleading if, at the time it becomes effective, it contains “an untrue statement of material fact or omit[s] to state a material fact required to be stated therein, or necessary to make the statements therein not misleading.” (Section 11(a)).

#### a) Persons who may be liable are:

- (1) Every person who signed the registration statement;
- (2) Every director of the issuer;
- (3) Every person about to become a director, who with his or her consent is named in the registration statement;
- (4) Every accountant, engineer, appraiser, attorney or other person who gives an expert opinion with respect to a part of the registration statement;
- (5) Every underwriter of the security; and
- (6) Any controlling person of the foregoing.

#### b) Defenses

Defendants other than the issuer who can demonstrate that they did not know and, after a reasonable investigation, did not have reason to suspect that the registration statement contained a material misstatement or omission may not be held liable.

### **2. False or Misleading Prospectuses or Oral Communications**

Section 12 of the 1933 Act permits purchasers to sue any seller or offeror of a security who used a prospectus or oral communication that was false or materially misleading. The seller may defend on grounds that it did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

### 3. Statute of Limitations

Section 13 of the 1933 Act provides a statute of limitations for actions under Section 11 or 12 of the Act: one year after the purchaser discovers the violation, and in any event no more than three years after the purchase.

## III. SECURITIES EXCHANGE ACT OF 1934

### A. Purpose of the 1934 Act

The 1934 Act was enacted “to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets.”

### B. Registration Requirements

The 1934 Act provides for the registration and, to one degree or another, the regulation of:

1. Issuers, including investment companies, with securities listed on a national securities exchange and all others with at least \$10,000,000 in total assets and 500 shareholders;
2. National securities exchanges;
3. Broker-dealers;
4. Associations of broker-dealers (currently only FINRA); and
5. Transfer agents.

### C. Disclosure Requirements

1. Issuers with securities registered under the 1934 Act (and, in some cases, with securities that were once registered under the 1933 Act) are required to:
  - a) File preliminary and final proxy solicitation material and comply with SEC rules.
  - b) File full annual reports with the SEC, as well as quarterly financials and current reports on material developments.
  - c) Send annual reports to shareholders.

2. Reports filed by investment companies satisfy both the 1940 Act and the 1934 Act requirements.
3. Disclosure requirements specific to investment companies include:
  - a) Annual and semi-annual reports to the SEC on Form N-SAR and Form N-CSR.
  - b) Annual and semi-annual reports to shareholders.
4. Individuals and groups that acquire more than 5% of the stock of an issuer with securities registered under the 1934 Act must file a report with the SEC and disclose what they intend to do. Tender offers and takeover attempts must conform with specific SEC rules and are subject to specific anti-fraud provisions.
5. The 1934 Act gives the Board of Governors of the Federal Reserve System authority to regulate extensions of credit used to purchase securities.

**D. Anti-Fraud Provisions**

1. Rule 10b-5 under the 1934 Act provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:

  - a) to employ any device, scheme, or artifice to defraud;
  - b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or
  - c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
2. Investors have an implied private right of action under Rule 10b-5, and may sue for damages based on activities prohibited by the Rule.
3. The courts have recognized a number of limitations, some of which are not expressly included in Rule 10b-5, which restrict recovery by investors:
  - a) The defendant, depending on the type of claim involved, must be:

- (1) A purchaser or seller,
  - (2) An issuer, or
  - (3) A broker-dealer, investment adviser, or similar fiduciary.
- b) The claim must involve some misconduct, misstatement, half-truth, or omission.
  - c) If a misstatement, half-truth, or omission is involved, it must be material in the sense that a reasonable investor would have considered the correct or missing information important when making an investment decision.
  - d) The defendant must have had the required “scienter,” i.e., the violation must be intentional or, in some situations, the result of recklessness.
  - e) There must be “privity,” i.e., the plaintiff must be a purchaser or seller or, where misconduct is involved, must have been owed the duty which is breached.
  - f) There must be “causation of damages” which, in certain cases, must involve reliance.
4. The SEC’s right to bring an action may be broader than that implied for private plaintiffs.

#### **IV. INVESTMENT COMPANY ACT OF 1940**

##### **A. Objectives of the 1940 Act**

1. The policy and purposes of the 1940 Act, as set forth in Section 1(b) of the Act, are “to mitigate and, so far as is feasible, to eliminate” certain conditions, enumerated in that section, which adversely affect the public interest and interest of investors. The enumerated abuses are:
  - a) Inadequate, inaccurate or unclear disclosure with respect to the investment company and its securities;
  - b) Self-dealing of insiders and of special interests;
  - c) Issuance of securities with inequitable terms and failure to protect the privileges and preferences of outstanding security holders;
  - d) Inequitable methods of control and irresponsible management;

- e) Unsound or misleading accounting methods;
  - f) Reorganizations, changes in policy, or transfers of control without consent of security holders;
  - g) Excessive borrowing and excessive issuance of senior securities which unduly increase the speculative character of the junior securities; and
  - h) Inadequate assets or reserves.
2. The basic purpose and supplemental aims are, in general, carried out by provisions which tend to:
- a) Secure a more responsible management;
  - b) Prevent transactions with the investment company to the detriment of the company and its security holders;
  - c) Prevent discrimination among and inequitable treatment of security holders;
  - d) Prevent the formation of companies with unsound capital structures, prevent the issuance of securities with inequitable features and eliminate cross-ownership, circular ownership and pyramiding;
  - e) Assure proper disclosure of the affairs of the investment company and the character of its securities; and
  - f) Increase the voice of shareholders in management.

**B. Definition of Investment Company**

In broad terms, an investment company is any arrangement by which a number of persons invest funds in a “company” that is itself engaged in investing in securities. “Company” is defined very broadly in Section 2(a)(8) of the 1940 Act as “a corporation, a partnership, an association, a joint stock company, a trust, a fund or any organized group of persons whether incorporated or not.”

There are three types of investment companies:

- 1. Face amount certificate companies;
- 2. Unit investment trusts; and

3. Management companies, which may be diversified or non-diversified and open-end (mutual fund) or closed-end.

The remaining sections of this outline deal almost entirely with open-end and closed-end management companies.

### **C. Other Provisions**

The 1940 Act contains other provisions relating to:

1. Registration and reporting;
2. Affiliated transactions;
3. Offering and redemption of investment company shares;
4. Sales load limitations;
5. Responsibilities of directors, including disinterested directors; and
6. SEC enforcement powers.

## **V. INVESTMENT ADVISERS ACT OF 1940**

### **A. Definition of Investment Adviser**

Section 202(a) of the Advisers Act defines an investment adviser as: "... 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."

There are several exclusions from the investment adviser definition. A person eligible for an exclusion is not subject to any provisions of the Advisers Act. The exclusions include, among others, U.S. banks and bank holding companies; lawyers, accountants, engineers and teachers if they are giving advice incidental to professional practice; and publishers. In 2011 the SEC adopted a rule excluding "family offices." Historically, many family offices were not required to register because of an exemption since repealed by the Dodd-Frank Act and other SEC guidance. A family office which manages the wealth and other affairs of a *single* family is excluded from the definition of investment adviser if it (1) has no clients other than family clients; (2) is wholly owned by family clients and exclusively controlled (directly or indirectly) by family members and/or certain family entities; and (3) does not hold itself out to the public as an investment adviser.

## **B. Registration of Investment Advisers**

### **1. Registration Requirement – Section 203(a)**

Unless exempted from registration by the statute, it is illegal for an investment adviser to make use of the mails or other means of interstate commerce to conduct its business, unless it is registered with the SEC.

### **2. Exemptions – Sections 203(a), 203(b), 203(l), 203(m)**

In 2011, the SEC adopted rules and rule amendments under the Advisers Act to implement certain provisions of Title IV of the Dodd-Frank Act. The Dodd-Frank Act repeals the “private adviser exemption” formerly in Section 203(b)(3) of the Advisers Act and replaces it with narrower exemptions from registration as an investment adviser for (a) advisers to venture capital funds, (b) advisers to private funds<sup>1</sup> with less than \$150 million in assets under management, and (c) certain foreign private advisers. The 2011 rule amendments also mandate certain reporting requirements on Form ADV for both registered investment advisers and advisers that qualify for the venture capital adviser exemption or the private fund adviser exemption – “exempt reporting advisers.”

Persons exempt from the registration requirement include the following:

- a) Any investment adviser, other than an investment adviser who acts as an investment adviser to any private fund, all of whose clients are residents of the state within which the adviser maintains its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange.
- b) Any investment adviser whose only clients are insurance companies.
- c) Any investment adviser that is a “foreign private adviser.” A “foreign private adviser” is an investment adviser that: (1) has no *place of business* in the U.S.; (2) has, in total, fewer than 15 *clients* and *investors in the U.S.* in private funds advised by the adviser;

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<sup>1</sup> Generally, a private fund is a hedge fund, private equity fund or other investment vehicle that is excluded from the definition of investment company under the Investment Company Act of 1940 (the “1940 Act”) by reason of Section 3(c)(1) or 3(c)(7) of the 1940 Act.

(3) has less than \$25 million of aggregate assets under management attributable to such clients and investors;<sup>2</sup> and (4) neither holds itself out generally to the public in the U.S. as an investment adviser nor advises mutual funds or business development companies. Advisers Act Rules define the italicized terms and should be consulted.

- d) Any investment adviser to a “venture capital fund.” This exemption is available if the investment adviser advises only private funds meeting the definition of “venture capital fund” or qualifying under a grandfathering provision. Rule 203(l)-1 defines a “venture capital fund” as a private fund that:
- holds no more than 20% of its capital commitments in non-qualifying investments (other than cash or cash equivalents) immediately after the acquisition of any asset (other than qualifying investments or cash or cash equivalents);
  - does not borrow or otherwise incur leverage in excess of 15% of its capital commitments, subject to certain exceptions;
  - does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;
  - represents to investors and potential investors that it pursues a venture capital strategy; and
  - is not registered under the 1940 Act and has not elected to be treated as a business development company.
- e) Any investment adviser solely to private funds with less than \$150 million of aggregate regulatory assets under management (“regulatory AUM”) in the United States. In order to qualify for this exemption, advisers can advise an unlimited number of private funds, provided that the aggregate regulatory AUM of the private funds is less than \$150 million. An adviser relying on the private fund adviser exemption must annually calculate the amount of regulatory AUM pursuant to instructions in Form ADV and report the amount in its annual updating amendment to its Form ADV.

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<sup>2</sup> The Advisers Act authorizes the SEC to raise this \$25 million threshold if it deems appropriate.

- f) Any investment adviser regulated as an adviser in the state where it has its principal office and which has less than \$25 million in assets under management. (All investment advisers to registered investment companies are subject to federal registration even if they have less than \$25 million under management.) SEC regulations also require a “mid-sized adviser” (an adviser with between \$25 million and \$100 million in regulatory AUM) to deregister with the SEC and instead register with the state securities authority in the state where it maintains its principal office and place of business, in most circumstances.

### **3. The Registration Process**

a) Registration

An investment adviser registers by filing Form ADV with the SEC, together with a non-refundable filing fee. The filing fee price, starting at \$150, is dependent upon the amount of assets under management. The registration statement automatically becomes effective on the 45th day after filing. The SEC may deny registration, after notice and hearing, to an adviser who has in the past engaged in conduct specified in Section 203(d) (e.g., securities fraud).

b) Form ADV

Section 203(b) prescribes various categories of information required in Form ADV, which is divided into two parts. Part I requires information primarily for regulatory purposes, and Part II requires disclosure information primarily for clients or prospective clients (to whom the adviser can furnish this information by delivery of Part II or a separate brochure pursuant to Rule 204-3).

### **C. Disclosure and the Brochure Rule**

1. Rule 204-3 (the “Brochure Rule”) requires an investment adviser to deliver to a client or prospective client a written statement containing information about the adviser’s background and business practices when entering into an advisory contract (other than one with a registered investment company or one that provides only for impersonal advisory services), or when entering into a substantially modified advisory contract with an existing client.
2. Delivery of the brochure to the client must occur:
  - a) at least 48 hours prior to entering into an advisory agreement; or

- b) at the time of entering into the agreement if the agreement gives the client the right to rescind the agreement with no penalty within five business days after entering into it.
3. The Brochure Rule is not a safe harbor. Advisers must still make all disclosures required by other federal and state laws and regulations, including the general fiduciary duty owed by advisers to their clients. This means in particular that although an adviser need not deliver updated brochures to existing clients under the rule, when material changes occur, the adviser's fiduciary duty to the clients may require such disclosure. (See Investment Advisers Act Release No. 664 (Jan. 30, 1979)).

#### **D. Custody of Funds and Securities**

Under the Advisers Act, it is fraudulent for any investment adviser to keep custody or possession of any funds or securities in which any client has any beneficial interest unless the adviser complies with Rule 206(4)-2.

#### **E. Regulation of Fee Arrangements and Other Contract Terms**

##### **1. General Rule – Section 205**

Section 205 of the Advisers Act prohibits investment advisers required to register under the Act from performing under any investment advisory contract if the contract:

- a) provides for compensation based on a share of capital gains or capital appreciation;
- b) does not prohibit the investment adviser from assigning the contract without the consent of the client; or
- c) does not require an adviser which is a partnership to notify the client of any changes in the membership of the partnership.

##### **2. Performance Fees**

Notwithstanding 1(a) above, Section 205 does not prohibit an investment adviser from entering into or performing an investment advisory contract that authorizes compensation of the adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or a portion of the funds of a client, *provided that* the client who is a party to this contract is a “qualified client” as defined by Rule 205-3(d)(1) under the Advisers Act or is an investment company, provided that in such case the fee is a so-called “fulcrum fee” as defined in Rule 205-2(a)(1) under the Act.

### 3. Referral Fees

The SEC staff has taken the position that *continuous* sharing in an advisory fee for client referrals, as opposed to payment of a one-time referral fee, raises serious questions under the Advisers Act which are not cured by disclosure. Generally, the SEC disapproves of the sharing of an advisory fee for client referrals on an ongoing basis. Marine Investment Management, Inc. (pub. avail. Nov. 2, 1971). Rule 206(4)-3, however, permits investment advisers to pay cash fees to solicitors if the solicitation arrangement is adequately disclosed to their clients.

### F. Anti-Fraud Provisions

Section 206 of the Advisers Act prohibits investment advisers from using instrumentalities of interstate commerce to defraud clients or engage in fraudulent practices. In SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963), the Supreme Court held that “fraud” as used in the Advisers Act does not mean fraud in a narrowly construed, common law sense. Instead, it held that an investment adviser owes the duties of a fiduciary to its clients.

## VI. STATE CORPORATE LAWS

### A. Areas Governed by State Corporate Law

An investment company must comply with the corporate or business trust laws of the state in which it is organized. These laws usually govern such areas as the formation, organization and operation of the investment company. Funds must comply with provisions specifically relating to:

1. Formation of the corporation or trust, the fund’s governing document, meetings of directors/trustees, and keeping of books and records.
2. Issuance of securities.
3. Dividends and other distributions.
4. Reorganizations.
5. Duties and responsibilities of directors/trustees, including functions, number, qualifications, election and tenure, removal and vacancies, and power and duties of officers and employees.
6. Shareholders, including requirements for annual meetings and special meetings, quorum requirements, proxy requirements, and rights of inspection.

## **VII. STATE SECURITIES LAWS**

### **A. Uniform Securities Act**

Most, but not all, states have adopted the Uniform Securities Act of 1985 with the 1988 amendments (“Uniform Act”). Additionally, the National Securities Markets Improvement Act of 1996 (“NSMIA”) has amended the 1933 Act to prohibit any law, rule, regulation, or other administrative action of any state from applying to the registration of securities that are “covered” as defined by Section 102 of NSMIA or meet other requirements contained in that section. However, nothing in NSMIA prohibits the securities commission of any state from requiring the filing of any documents filed with the SEC pursuant to the securities laws solely for notice purposes, together with a service of process consent and any mandatory fee. Accordingly, state securities laws that are modeled on the Uniform Act generally consist of the following three parts:

#### **1. Registration of Securities**

- a) Section 301 of the Uniform Act provides that every security offered or sold in that state be registered or exempt from registration. Qualification of securities for which a registration statement has been filed under the 1933 Act in connection with the offering of the securities may be accomplished in various ways.
- b) If securities offerings are exempt from state regulations pursuant to NSMIA, simple notification of an offering of securities is required prior to offering and sales.

#### **2. Registration of Broker-Dealers, Agents and Investment Advisers**

- a) Section 201 of the Uniform Act requires the registration of all broker-dealers, agents and investment advisers who are operating in a state or selling securities or offering investment advice from outside a state to persons in that state. Investment advisers are required to register in states only if they are not registered with the SEC or have actual presence in a state.
  - (1) Section 401(c) defines persons who are “broker-dealers.”
  - (2) Section 401(b) defines the term “agent.” It excludes, among others, persons who are selling securities on behalf of an issuer where the securities are exempt from the registration requirements under one of the transactional exemptions of Section 402(b) or certain of the securities exemptions of Section 402(a).

- (3) Section 401(f) defines persons who are “investment advisers.”
- b) Failure to register as a broker-dealer, an agent or an investment adviser is a felony punishable under Section 409.

### **3. Anti-Fraud Provisions**

- a) Section 101 of the Uniform Act prohibits the following types of conduct:
  - (1) Employing any device, scheme or artifice to defraud;
  - (2) Making any untrue statement of material fact or omitting a statement of material fact; and
  - (3) Engaging in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

A violation of Section 101 will subject the violator to criminal liability under Section 409 and to a civil injunction under Section 408. However, Section 101 does not impose civil liability upon the violator.

- b) Section 410(a)(2) imposes liability for offering or selling securities by means of any untrue statement of material fact or any material omission of such a fact. Liability is based upon an inverse negligence standard – a defendant, to avoid liability, must prove that he or she did not know or could not, in the exercise of reasonable care, have found out about the material fact omitted or misstated.

## **VIII. MUTUAL FUND REGULATORS**

### **A. Securities and Exchange Commission**

#### **1. The SEC in General**

The laws governing investment companies require extensive disclosure to the SEC and entail continuous regulation of fund operations. The SEC regulates the following principal fund-related areas under the federal statutes listed below:

- a) Securities Act of 1933

- (1) Disclosure to shareholders about the fund's management, its investment policies and objectives, and its investment activities.
  - (2) The required filing of full information regarding a fund with the SEC.
- b) Securities Exchange Act of 1934
- (1) Fraud in the purchase and sale of fund shares.
  - (2) Disclosure and proxy requirements for shareholder meetings.
- c) Investment Advisers Act of 1940
- (1) Disclosures to advisory clients.
  - (2) Activities of investment advisers to funds.
- d) Investment Company Act of 1940
- (1) Disclosures to shareholders.
  - (2) Fund management.
  - (3) Record retention and reports of independent auditors.
  - (4) Capitalization and capital structure.
  - (5) Reorganizations, changes in policy and transfers of control.
  - (6) Transactions with affiliates.

## **2. Division of Investment Management**

Within the SEC, the Division of Investment Management regulates investment companies, including mutual funds, and investment advisers. The Division is responsible for implementing regulations under the 1940 Act and the Advisers Act. The staff of the Division is also responsible for review of all investment company registration statements and amendments thereto, proxy statements and all periodic report filings. The staff of the Division considers requests for exemptive relief from the 1940 Act and requests for "no-action" positions.

**B. State Securities Commissions**

In addition to the regulation of the industry by the SEC, the various states have regulations which affect investment company operations. The state securities commissions:

1. Require notice filings for securities offered to their residents.
2. Require the registration of broker-dealers who offer securities in their states.

**C. The U.S. Commodity Futures Trading Commission**

In February 2012 the CFTC adopted amendments to CFTC Regulation 4.5 which require certain investment advisers to registered investment companies to register with the CFTC as “commodity pool operators” under the Commodity Exchange Act (CPOs).

- a) Historically, most advisers to registered investment companies that used either futures or options on futures claimed relief from registration as CPOs, pursuant to an exclusion set forth in Regulation 4.5. The amendments to CFTC Regulation 4.5 now require the operators of registered investment companies to either limit such companies’ use of futures contracts, options on futures contracts, leverage contracts, retail forex contracts, and swaps (together, “commodity interests”) or register as CPOs and submit to dual regulation by the CFTC and the SEC.
- b) In amending Regulation 4.5, the CFTC recognized that CFTC and SEC requirements for dual registrants required harmonization because many of them are duplicative or inconsistent. On August 13, 2013, the CFTC adopted harmonization rules (“Harmonization Rules”) for operators of registered investment companies that are subject to registration as CPOs. The Harmonization Rules address regulatory issues that registered investment companies and their advisers or operators face under dual regulation by the CFTC and the SEC.
- c) On the day following the CFTC’s adoption of the Harmonization Rules, the SEC’s Division of Investment Management published an “Investment Management Guidance Update” summarizing SEC staff views regarding certain disclosure and compliance requirements for registered investment companies that invest in commodity interests. The IM Guidance largely reiterates past SEC staff guidance and emphasizes the importance of complete, accurate and current disclosure regarding fund investment strategies and risks related to use of commodity interests, as well as robust supporting compliance policies. The IM Guidance is intended to assist

registered fund CPOs that comply with certain Harmonization Rule requirements in also remaining in compliance with SEC requirements.

#### **D. Self-Regulatory Organizations**

A third layer of regulation is imposed by various “self-regulatory” organizations.

##### **1. Stock Exchanges**

Each registered national securities exchange has self-regulatory responsibilities. Each exchange establishes regulatory requirements for broker-dealers which voluntarily purchase memberships. Each exchange also establishes requirements for issuers desiring to list on the exchange (a category that includes many closed-end funds), which may require the filing of information with the exchange in addition to that filed with the SEC.

##### **2. Financial Industry Regulatory Authority, Inc. (“FINRA”)**

FINRA, the self-regulatory organization resulting from the 2007 consolidation of the National Association of Securities Dealers, Inc. and the member regulation, enforcement and arbitration functions of the New York Stock Exchange, is responsible for the regulation of broker-dealers, including mutual funds’ principal underwriters and dealers in fund shares.

- a) In general, all broker-dealers registered with the SEC must register with and become members of FINRA. FINRA is a “self-regulatory” organization whose purpose includes regulation of broker-dealers.
- b) FINRA also regulates investment company advertising, underwriting arrangements with investment companies, and compensation to broker-dealer members from investment companies and from purchasers of their shares.

#### **E. Entities Created under the Dodd-Frank Act**

##### **1. Financial Stability Oversight Council (“Council”)**

The Council is an interagency council established under the Dodd-Frank Act to “identify risks to the financial stability of the U.S.” “promote market discipline” and “respond to emerging threats to the stability of the U.S. financial system.”

- a) If the Council determines that the “material financial distress” at a nonbank financial company or the “nature, scope, size, scale, concentration, interconnectedness, or mix of the activities” of a nonbank financial company could pose a threat to the financial stability of the U.S., the company can be required to be supervised by the Federal Reserve Board of Governors (“Board”) and to be subject to certain prudential standards.
- b) The Council may consider the activity of a pooled vehicle, such as a registered investment company, or of its investment adviser to fall under supervision by the Board. Certain of the factors that the Council must consider appear to weigh against its deeming a mutual fund or its investment adviser to be systemically important and, thus, subject to Board supervision. Nevertheless, it is possible that the Council could have systemic concerns about large fund complexes and their managers.

## 2. Bureau of Consumer Financial Protection

Although the much-publicized the Bureau of Consumer Financial Protection has responsibility for regulating the offering and provision of a wide range of consumer financial products and services, it has no jurisdiction over registered investment companies.

## IX. SUBCHAPTER M OF THE INTERNAL REVENUE CODE

### A. General

The Internal Revenue Code generally puts investment company shareholders in the same tax position that they would be in if they directly owned the securities in the fund’s portfolio. The Code accomplishes this result by treating investment companies essentially as conduits, thereby avoiding the imposition of a federal income tax burden on a person’s investment through funds that would be heavier than the tax burden on persons who can afford to invest directly.

1. Investment companies, which are known in Subchapter M of the Code as “regulated investment companies,” are treated as corporations under the Code. However, they are allowed a deduction and are relieved of federal income tax at the fund level to the extent they distribute their net income to shareholders.
2. Each portfolio of a series fund is taxable as a separate corporation for all income tax purposes, including the qualification tests of Subchapter M. (The division of existing series funds into separate corporations is permitted on a tax-free basis.)

3. To qualify as a regulated investment company, a fund must meet various requirements:
  - a) It must be registered with the SEC under the 1940 Act as a management investment company at all times during the taxable year.
  - b) It must affirmatively make an election to be taxed as a regulated investment company. (This election is made on its annual return.)
  - c) It must derive at least 90% of its gross income from dividends, interest payments with respect to securities loans, and gains from the sale or other disposition of stock or securities.
  - d) At the close of each quarter of the fund's taxable year, at least 50% of the value of its total assets must be represented by cash, cash items, government securities, securities of other regulated investment companies and, subject to certain diversification requirements, other securities.
4. The tax laws of most states provide identical conduit income tax treatment for investment companies and their shareholders.

**B. Effect of Qualifying**

Qualification as a regulated investment company results in significant tax advantages:

1. A regulated investment company that distributes at least 90% of its ordinary income (interest and dividends) to shareholders can deduct those payments from income and pay taxes only on the amounts, if any, that it retains.
2. Regulated investment companies are exempt from corporate income tax on capital gains distributed to shareholders. Gains so distributed are taxable to shareholders at capital gains rather than ordinary income rates.
3. Undistributed capital gains are taxable at the corporate level. Shareholders must include their portions of such gain on their individual returns despite the fact that no gains have been distributed. Shareholders are permitted, however, to take a proportionate credit for the tax paid by the fund.
4. Funds that invest primarily in tax-free municipal securities are able to pass through to their shareholders the tax-free nature of the income on those securities.

## **X. EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974**

### **A. Overview of ERISA**

ERISA establishes principles of fiduciary conduct and responsibility applicable to persons dealing with retirement plans and trust funds. In this Act, Congress attempted to codify and clarify “certain principles developed in the law of trusts.” Congress undertook this codification and clarification because:

1. It was not clear that the traditional law of trusts applied to many retirement plans.
2. Reliance on conventional trust law was often insufficient to adequately protect the interests of plan participants and beneficiaries. Conventional trust law developed around testamentary and *inter vivos* trusts where the primary emphasis was on carrying out instructions of the settlor, rather than protecting the interests of the beneficiaries.
3. There was a lack of detailed information about plans and about the standards of fiduciary conduct. This meant that meaningful access to the courts was difficult for plan participants and their beneficiaries.
4. The operation of employee benefit plans was of an increasingly interstate nature, and the application of uniform principles was therefore desirable and necessary.

### **B. Structure of ERISA**

ERISA is composed of four titles. Title I deals with protection of employee benefit rights and is administered by the Department of Labor. It covers reporting and disclosure, fiduciary standards, participation and vesting, funding, and other topics related to employee rights. Title II consists of amendments to the Internal Revenue Code and is administered by the IRS. Title III deals with the division of responsibilities among the agencies administering the law. It also creates overlapping authority between the Department of Labor (“DOL”) and the IRS. Title IV deals with plan termination insurance and creates the Pension Benefit Guarantee Corporation.

### **C. Scope of ERISA**

1. The fiduciary standards of ERISA apply to all employee benefit plans under Commerce Clause jurisdiction other than: government or church plans; plans required under workman’s compensation, unemployment compensation, and disability insurance laws; plans established or maintained outside the United States for the benefit of non-U.S. citizens; and unfunded deferred compensation plans for executives. The standards

apply to the discharge of all duties of a fiduciary and are not limited to investments.

2. Persons performing services for a plan subject to ERISA become “parties in interest” and are prohibited from engaging in certain types of transactions with the plan, unless an exemption applies. To the extent a person has discretionary control over the assets or administration of a plan subject to ERISA, the person will be a “fiduciary” for purposes of ERISA and subject to ERISA’s fiduciary standards and additional prohibitions in connection with its relationship to the plan.
3. Generally, ERISA does not apply to the assets of a registered investment company in which plans invest. Nevertheless, the prohibited transaction provisions of ERISA may apply if the investment company is an investment option available under a plan for which an affiliate of the investment company provides services. Also, information regarding fees received by certain service providers to an investment company in which a plan invests may be required to be provided to the plan for purposes of the plan’s reporting requirements to the IRS and DOL.

## **XI. SARBANES-OXLEY ACT OF 2002**

### **A. Overview of Sarbanes-Oxley Act**

The stated purpose of the Sarbanes-Oxley Act is to restore investor confidence in the securities markets through sweeping reform to existing corporate disclosure and financial reporting requirements. The Act creates a new oversight board for the accounting profession, mandates new measures to promote auditor independence, adds new disclosure requirements for public companies and investment companies, and strengthens criminal penalties for securities fraud. The Act applies to all public company issuers of securities, including registered investment companies.

### **B. Investment Company Reports and Disclosure**

#### **1. Form N-CSR**

The Sarbanes-Oxley Act directs the SEC to issue rules requiring an issuer’s principal executive officer(s) and principal financial officer(s) (“Principal Officers”) to certify the information contained in each annual or quarterly report filed with the SEC under the 1934 Act. In response, the SEC adopted new and amended form rules (“Amendments”), including Form N-CSR. The Amendments require that open-end and closed-end management investment companies file certified shareholder reports with the SEC, semi-annually, on Form N-CSR. An investment company’s

report on Form N-CSR must contain: (i) a copy of the required shareholder report; (ii) new disclosures concerning the fund's "audit committee financial expert(s)," disclosure controls and procedures, and a code of ethics; and (iii) the certification prescribed by the form. The report must be signed by the fund, and on behalf of the fund by each of its Principal Officers.

a) Audit Committee Financial Expert

An investment company is required to disclose in its annual report on Form N-CSR that its board of directors has determined that the fund either: (i) has at least one audit committee financial expert on the fund's audit committee and, if so, the name of the expert and whether the expert is "independent," or (ii) does not have an audit committee financial expert serving on its audit committee and, if so, why.

b) Disclosure Controls and Procedures

An investment company is required to maintain, and its Principal Officers are required to evaluate regularly, the effectiveness of its "disclosure controls and procedures." Rule 30a-3(c) under the 1940 Act defines "disclosure controls and procedures" as controls and procedures designed to ensure the information disclosed by the investment company on Form N-CSR is recorded, processed, summarized and reported within the time periods specified by SEC rules and forms, including those designed to ensure information is accumulated and communicated to the investment company's Principal Officers to allow timely decisions regarding required disclosure.

c) Code of Ethics

An investment company is required to disclose in its annual report on Form N-CSR whether the fund has adopted a written code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and, if not, why. An investment company is also required to make its code of ethics available to the public.

**2. Disclosure of Non-Audit Services and Pre-Approval Procedures**

The Sarbanes-Oxley Act requires an issuer to disclose in its periodic reports to investors all non-audit services pre-approved by its audit committee. Under the SEC rules implementing this requirement, an

investment company must make certain disclosures, for the fund's two most recently completed fiscal years, in its annual report on Form N-CSR, or in any proxy statement relating to the election of directors or the approval or ratification of the fund's independent registered public accounting firm (the "auditor").

### **3. Certification of Periodic Reports**

An investment company's Principal Officers are required to certify the information contained in the fund's report on Form N-CSR. The certification applies to all aspects of annual and semi-annual shareholder reports, whether its inclusion in the report was mandatory or voluntary. The certification must be in the exact form specified by Form N-CSR.

### **4. Improper Influence on the Conduct of Audits**

Section 303 of the Sarbanes-Oxley Act makes it unlawful for any officer or director of an issuer fraudulently to influence, coerce, manipulate or mislead any independent public accountant engaged in the performance of an audit of the company's financial statements for the purpose of rendering the company's financial statements materially misleading.

## **C. Investment Company Audit Committees**

### **1. Pre-Approval of Audit and Non-Audit Services**

An investment company's audit committee is required to pre-approve the engagement of an investment company's independent auditor and all audit services to be provided to the investment company by the auditor. An investment company's audit committee must also pre-approve all non-audit services.

### **2. Pre-Approval Procedures**

Pre-approval by an audit committee may be accomplished by establishing pre-approval policies and procedures, which are designed to safeguard the continued independence of the auditor.

## **D. Investment Company Auditors**

### **1. Independence Standards**

#### **a) Cooling-Off Period**

An investment company's auditor will not be deemed independent if, during the audit period prior to the current audit period, any former member of the fund's audit engagement team is employed

“in a financial reporting oversight role” by the fund or any entity in the fund’s complex that is responsible for the financial reporting or operations of the fund or any other investment company in the fund’s complex.

b) Compensation

An investment company’s auditors will not be deemed independent if, at any time during the audit and professional engagement period, any audit partner earns or receives compensation for procuring engagements for non-audit services from the fund or any entity in the fund’s complex.

c) Non-Audit Services

The Sarbanes-Oxley Act includes a broad prohibition on the performance, by an independent auditor, of non-audit services for audit clients.

**2. Partner Rotation**

The Sarbanes-Oxley Act prohibits the lead and concurring audit partners from serving on an audit engagement for more than five consecutive years.

**3. Audit Committee Reports**

An investment company’s auditor is required to report to the fund’s audit committee on an annual basis, either orally or in writing: (i) all critical accounting policies and practices to be used; (ii) all alternative treatments of financial information discussed with fund management; (iii) all other written communications between the auditor and fund management; and (iv) all non-audit services provided to an entity in the fund’s complex that were not pre-approved by the fund’s audit committee.

**E. Legal Counsel**

All attorneys who provide legal services to, and have an attorney-client relationship with, an investment company are required to report to an investment company’s chief legal officer (“CLO”), or to both the CLO and the fund’s chief executive officer, or, alternatively, to a Qualified Legal Compliance Committee of the fund, any information the attorney becomes aware of that constitutes “credible evidence based upon which it would be unreasonable under the circumstances for a lawyer not to conclude that it is reasonably likely that a material violation has occurred, is occurring or is about to occur.”

**1. Supervising and Subordinate Attorneys**

The implementing rule adopted by the SEC specifically delineates the roles of supervising and subordinate attorneys. A supervising attorney is one who supervises or directs another attorney who is appearing and practicing before the SEC in the representation of an issuer. A subordinate attorney is one who appears and practices before the SEC in the representation of any issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's CLO).

**2. Noisy Withdrawal**

The SEC issued a subsequent proposal requesting additional comment on the "noisy withdrawal" provision in the initial proposal. The provision would require an attorney to withdraw from representing an issuer, and to give notice of the withdrawal to the SEC, if an appropriate response is not made after a report to the highest authority in an investment company organization of a violation threatening serious harm to investors. The subsequent proposal seems to allow for two alternatives to noisy withdrawal. The SEC has yet to issue a final rule on the matter.