K&L GATES

ORGANIZING A MUTUAL FUND

I. SELECTING THE ORGANIZATION FORM – CORPORATIONS AND BUSINESS TRUSTS

Investment companies are organized as corporations or business trusts (or, occasionally, limited partnerships) under state law. The organizers have to choose the form of organization and the state in which to organize.

A. Corporations

The most common form of organization for investment companies is the corporation. The corporate form remains attractive because of the traditional protection from liability afforded to shareholders and, to a lesser degree, directors. At one time, the corporate venue of choice was Delaware, but Maryland corporations have become increasingly popular because Maryland corporate law has removed a number of corporate encumbrances for investment companies.

B. Business Trusts

A business trust is an unincorporated association governed by a board of trustees. Business trusts are created when trustees sign a trust instrument, often called a declaration of trust, and file the document with the state of organization. Most mutual funds employing the business trust form are organized under Delaware or Massachusetts law (in Delaware, such entities are designated by statute as "statutory trusts"). In both states, the business or statutory trust form is burdened by few substantive limitations, offering a high degree of operational and organizational flexibility. In Delaware, comprehensive statutory provisions provide guidance.

C. Comparison of Primary Modes of Organization

	Issue	Massachusetts Business Trusts	Delaware Statutory Trusts	Maryland Corporations
1.	Shareholder Liability	Remote possibility of shareholder liability that must be disclosed in statement of additional information; should attempt to limit by declaration of trust and/or contractual provisions.	Limited by statute that provides for liability – equivalent to that afforded shareholders of Delaware corporation. However, certain states (e.g., Texas) may not recognize Delaware law on this issue. Should attempt to limit by trust instrument and/or contract.	Limited by statute.
2.	Trustee/ Director Liability	May be limited by declaration of trust and/or contractual provisions.	May be limited by trust instrument and/or contractual provisions. Also, recognized by statute.	May be limited by charter provisions; may indemnify directors for acts not involving bad faith, active and deliberate dishonesty, improper personal benefit.
3.	Annual Shareholder Meetings	No statutory requirement; only if required by declaration of trust.	Only if required by declaration of trust.	No statutory requirement; only if required by articles of incorporation.
4.	Shareholder Approval of Certain Actions	No statutory requirement; only if required by trust instrument.	No statutory requirement; only if required by trust instrument.	– Merging, consolidating or selling all or substantially all of the assets; – Spinning a series off to become a separate corporation; – Changing domicile; – Amending articles of incorporation; – Dissolving the corporation.
5.	Ability to Amend Organization Document	Subject to provisions of declaration of trust.	Trustees may amend the trust instrument regarding management of the trust, rights and obligations of the trustees and shareholders without shareholder vote.	Shareholder vote required to amend articles of incorporation.
6.	Numbers of Authorized Shares	Unlimited.	Unlimited.	Articles of Incorporation must provide for a definite number of shares to be issued, which may be

	Issue	Massachusetts Business Trusts	Delaware Statutory Trusts	Maryland Corporations
				increased by board of directors without shareholder approval.
7.	Treatment of Multiple Classes/Series	Subject to provisions in declaration of trust.	Statute specifically recognizes separation of class/series.	Statute specifically recognizes separation of classes. Board of directors authorized by statute to classify or reclassify unissued stock.
8.	Development of Controlling Law	Law is not well-developed and subject to much interpretation. Massachusetts corporation law is often used by analogy.	Law of business associations is highly developed and, to the extent such law applies to Delaware statutory trusts, provides somewhat clearer guidelines as to obligations and rights of the Delaware statutory trust and its shareholders.	Corporate law is well-developed, providing probably the most clear guidelines to the rights and obligations that apply to a fund formed as a Maryland corporation.
9.	State Income Taxation	None.	With some exceptions, the net income of regulated investment companies is the same as its federal investment company taxable income, i.e., none if it meets certain requirements.	With some exceptions, the net income of a regulated investment company is the same as its federal investment company taxable income, i.e., none if it meets certain requirements.
10.	Franchise Taxes	None.	Franchise tax that applies to regulated investment companies.	None.

II. THE ORGANIZATION PROCEDURE

In connection with the organization of any entity, certain statutory and/or organizational actions must be taken before the entity commences operations, including the following:

A. Articles of Incorporation or Declaration of Trust

The articles of incorporation or declaration of trust establish an entity's legal existence. In the case of a corporation, the articles are filed with the state, which typically issues a certificate of incorporation. In the case of a business or statutory trust, a certificate is typically filed with the state. The articles of incorporation and declaration of trust typically set forth the powers, duties and obligations of the corporation or trust in broad terms. Matters addressed in these documents usually include the following: (1) entity name, (2) number of directors/trustees, (3) purpose clause, (4) powers clause, and (5) special clauses, such as the indemnification of directors/trustees. In most cases, certain provisions of the articles of incorporation or declaration of trust can be amended only by a vote of shareholders.

B. By-Laws

An entity's by-laws are generally prepared at the time the entity is organized and govern the internal management of the entity. While the articles of incorporation or declaration of trust are concerned with broad matters, the by-laws cover more technical issues relating to management such as the election of directors, the appointment of committees, the duties of officers, the conduct of board and shareholder meetings, and other similar issues. The by-laws can usually be amended by the directors/trustees themselves without shareholder approval.

C. Organizational Meeting

Before an entity commences operations, it typically holds an organizational meeting of its directors or trustees. At the meeting, the directors or trustees take all actions to allow the entity to commence doing business, including the following: (1) the formal election of directors/trustees and officers, (2) the ratification of the articles of incorporation/declaration of trust and adoption of the by-laws, and (3) the transaction of other business, including approval of arrangements with fund service providers (such as its investment adviser, transfer agent, distributor and custodian), adoption of procedures, and the conduct of other actions mandated by regulatory requirements or that are otherwise deemed appropriate. See, e.g., Chapters 4 and 11.

III. SEPARATE FUND ENTITIES AND SERIES FUNDS

A. In General

If a fund sponsor plans to offer more than one registered investment company, it must decide how it will create those portfolios. On the one hand, the sponsor may create a separate corporation or trust for each fund. On the other hand, the sponsor may use a single legal entity to offer multiple portfolios or "series" of shares, each having different investment objectives, policies, and potential investors, i.e., a "series fund."

B. Series Companies

1. Structure

Each series in a series fund represents a segregated portfolio of the fund's assets. A single board of directors governs the series fund. Each series must vote separately on matters not affecting all series alike. For example, each series must vote to approve its investment advisory agreement (which may differ for each series), or to approve changes in fundamental investment policies.

2. Potential Advantages

a. A series company can eliminate duplication of various activities and expenses, including (1) initial and ongoing organizational expenses, such as legal, incorporation and ongoing state doing-business fees, and (2) the preparation and filing of multiple registration statements, periodic reports and other regulatory filings.

(1) Unlike with a separate entity, a new fund formed as a series of an existing registrant can obtain automatic effectiveness within 75 days of filing its registration statement. See Rule 485(a)(2) under the 1933 Act.

(2) Creation of a new series does not require the sponsor to invest $100,000 seed capital; this is required only for new registrants, i.e., new corporations or trusts.

3. Potential Disadvantages

a. With respect to company-wide votes, such as the election of the fund's board of directors and approval of the fund's auditors, holders of similar numbers of shares in different series may have the same voting power, despite any disparity in the net asset values of their shares. To avoid this problem, some funds have arranged to have shareholder votes determined by the dollar value of shares rather than the number of shares.

b. Although we are not aware of any court decisions on this point, one series of a company potentially could be liable for the liabilities of one or more other series in the company. This risk is generally considered remote. The Delaware statutory trust statute specifically recognizes the separation between series.

c. Certain judicial rulings have given the shareholder of one series standing to sue a sponsor on behalf of all series in a fund for allegedly excessive management fees. See, e.g., Barrett v. Van Kampen Merrit Inc., No. 93-C-366 (N.D. Ill. Mar. 30, 1993).

d. The corporation and trust laws of some states do not expressly recognize the separation of assets and liabilities into separate series. It is a wise idea to specify in fund contracts that no series is liable for any debt or obligation of any other series.

C. Separate Fund Entities

Series funds are subject to the theoretical risks of being liable for the debts of other funds discussed above. There is little or no other advantage to offering a family of funds with a separate legal entity for each fund. Multiple legal entities inevitably require duplication and expense resulting from separate governing boards, periodic reports, and other regulatory filings. However, maintaining too many series in the same entity can cause administrative difficulties in handling board meetings and preparing and filing shareholder reports and registration statements, which are usually on the same schedule for all series. Thus, many fund sponsors with a large number of funds use several series companies, each containing several series, and often having different fiscal year-ends.

IV. METHODS OF MULTI-LEVEL DISTRIBUTION: MULTIPLE CLASS AND MASTER-FEEDER ARRANGEMENTS

A. Introduction

1. Background

There has been substantial growth in the offering/sales arrangements that accompany each investment product offered by mutual funds. There are several distinct markets for funds, including retail (including direct-sold and broker-sold) and institutional (primarily banks and pension plans). Each selling arrangement is designed to enable a product to reach and satisfy a broader range of investors by offering an alternative with respect to the cost and service features applicable to the investment product. Each has its own distinct needs and appropriate fee structure. Initially, fund groups addressed these distinct needs by establishing two or more virtually identical "clone" funds, each of which would be offered to different markets. More recently, the fund industry has attempted to develop structures that enable funds to be offered in different markets more efficiently.

2. **Section 22(d) and Rule 22d-1**

The innovations that have occurred in the packaging of mutual fund products have overcome in large part the constraints imposed on the sale of fund shares by the 1940 Act.

a. Section 22(d) of the 1940 Act prohibits a fund, its principal underwriter, or a dealer in its securities from selling such securities to any person except at a current public offering price described in the fund's prospectus. Rule 22d-1, as amended, permits any scheduled variation in sales charges provided that it is applied uniformly to all offerees in the class specified. See Investment Company Act Release No. 14390 (Feb. 22, 1985).

b. Section 18(f)(1) of the 1940 Act prohibits an open-end investment company from issuing any senior security. Pursuant to the definition of a senior security in Section 18(g) as interpreted by the SEC, a multiple class arrangement would cause the issuance of a senior security.

c. In order to provide further flexibility, marketing innovations such as the "multiple class" structure and the "master-feeder" structure have been developed.

B. **Master-Feeder Funds**

1. **Background and Structure**

a. The master-feeder structure basically divides the functions of the traditional mutual fund into two parts – a master fund and one or more feeder funds. Public investors invest in the feeder funds. The feeder funds invest in the master fund, which, in turn, invests in the individual securities. Through several feeder funds, a single investment pool can present several different faces to the public.

(1) Portfolio management and custody functions occur at the master fund level.

(2) Distribution, shareholder servicing, and transfer agent functions are focused at the feeder funds level.

b. The Master Fund

(1) For federal tax purposes, the master fund is usually organized as a common law trust (taxable as a partnership).

(2) The master fund is primarily engaged in the purchasing, holding and selling of securities and must register as an investment company under the 1940 Act.

(3) Like a traditional single-tiered mutual fund, the master fund retains an investment adviser to manage its portfolio as well as a custodian to hold its assets and that custodian or another entity to perform the fund accounting functions. Thus, the master fund incurs investment advisory and custodial fees as well as some fund administration expenses.

(4) Interests in the master fund are sold privately only to one or more feeder funds. Because the master fund interests are not publicly offered, the offering does not require registration under the 1933 Act, and the master fund does not incur any significant distribution, transfer agent or shareholder servicing expenses.

c. The Feeder Funds

(1) Feeder funds can be registered investment companies as well as unregistered offshore funds, bank collective funds for pension fund assets that are exempt from registration under the 1933 Act and the 1940 Act, and other institutional accounts exempt from registration.

(2) Each feeder fund may have administration, distribution and transfer agent expenses but, because it invests all of its assets in a master fund with the same investment objectives, it normally will incur little or no investment management or custodial expenses.

(3) Because a feeder fund is a separate legal entity, it has its own board, auditors and legal counsel.

(4) Feeder funds that are registered investment companies can be organized as separate corporations or business trusts or as series companies, with each series investing in a different master fund. For tax reasons, two series of the same feeder fund should not invest in the same series of the master fund.

2. Regulatory Treatment of Master-Feeder Funds

a. Investment Company Act of 1940

(1) A master fund is required to register under the 1940 Act as an open-end management investment company and is subject to the full panoply of 1940 Act regulation. This means that the master fund must file with the SEC a Form N-8A Notification of Registration and a Form N-1A registration statement designating 1940 Act registration. The master fund must also comply with the capital structure, corporate governance and affiliated transaction restrictions of the 1940 Act. Because there is a great deal of similarity in the Form N-1A filings of the master and feeder funds, the master fund is permitted to incorporate by reference from a feeder fund's Form N-1A. See, e.g., Eaton Vance Funds, Inc. and Neuberger & Berman Funds (pub. avail. Dec. 12, 1996).

(2) Section 12(d)(1) of the 1940 Act contains limitations that restrict the amount which an investment company may invest in another investment company and thereby generally prevents the establishment of fund holding companies, i.e., fund of funds arrangements. The master-feeder structure is able to take advantage of an exception to these limitations for investment companies that invest exclusively in a single investment company security. See Section 12(d)(1)(E).

b. Securities Act of 1933

(1) As noted above, the master fund does not make a public offering of its shares. Instead, its shares are issued only to the feeder funds and, as such, offerings of interests in the master fund have been treated as exempt from registration under the private offering exemption contained in Section 4(2) of the 1933 Act. The absence of registration under the 1933 Act for offerings of interests in the master fund is essential to the feasibility of the master-feeder structure under U.S. tax law. If interests in the master fund were deemed to be "publicly offered," the master fund could be categorized as a "publicly traded" partnership, an entity that is treated as a corporation for federal income tax

purposes. Such treatment could cause the master fund not to qualify for flow-through tax treatment.

(2) The SEC exempts the master fund from 1933 Act registration on the condition that feeder fund registrants include the following in their registration statements:

(a) the information material to the master fund's operations, including information relating to the master fund's investment objectives and policies; its investment advisers, administrators, and custodians; and the execution of its portfolio transactions;

(b) a consolidated fee table setting forth all expenses of both the master and feeder funds; and

(c) all the financial statements that would be contained in a master fund registration statement.

(3) In addition, the SEC staff requires the master fund and its principal officers and directors to sign each feeder fund's registration statement, thereby exposing them to potential liability for false or misleading registration statements under Section 11 of the 1933 Act.

C. <u>Multiple Class Funds</u>

1. <u>Background and Structure</u>

a. Under multiple class arrangements, a single registered investment company, or series thereof, issues two or more separate classes of shares to investors. By definition, the assets of the company or series, as applicable, are invested in a single pool. A single board of directors oversees the business affairs of the entire company and bears fiduciary responsibility for the interests of the shareholders of each class of shares. Classes of shares of an investment company or series can differ with respect to fees and charges that can be characterized as related to distribution and, to a limited extent, with respect to fees for certain administrative services.

b. Probably the two most popular types of multiple class arrangements are the following:

(1) Companies offering a choice of two or more classes of shares to a single category of investor. Sponsors of this type of class structure typically offer investors the option of purchasing either a class of shares subject to a front-end sales charge and a low or no ongoing Rule 12b-1 distribution fee (often called "Class A" shares), or a second class of shares without a front-end sales charge but subject to a higher Rule 12b-1 distribution fee and a contingent deferred sales load (often called "Class B" shares). Sponsors may also offer the latter class of shares with a conversion feature under which shares convert to shares of the lower expense class after sufficient time has passed for the distributor to recover its initial investment in distribution costs.

(2) Companies offering multiple classes of shares, each targeted for purchase by a different category of investor. This type of multiple class arrangement is commonly used by mutual fund sponsors that offer funds through different distribution channels, such as directly to retail investors, institutional investors, and through brokers and/or other financial intermediaries. The distribution and administration fees of these classes tend to differ based upon the differing level of costs that the sponsor expects to incur in relation to each class.

2. <u>Regulatory Treatment of Multiple Class Funds</u>

a. Because the issuance of multiple classes of shares would generally be deemed to constitute the prohibited issuance of a senior security under the 1940 Act, a fund must comply with Rule 18f-3 under the 1940 Act or obtain exemptive relief from the SEC in order to use a multiple class structure.

b. Rule 18f-3

In 1995, the SEC adopted Rule 18f-3 under the 1940 Act to permit mutual funds to issue multiple classes of shares without first obtaining exemptive relief. <u>See</u> Securities Act Release No. 7143 (Feb. 23, 1995). Set forth below are the relevant conditions of the Rule.

(1) Variation Among Classes

(a) The Rule requires that each class have a different arrangement for shareholder services or distribution of securities, or both. Arrangements qualify if there are differences in the amount or form of payment or the nature and extent of services provided, or both.

(b) The Rule permits each class to have other expense differences that are either (a) related to the shareholder services or distribution arrangement, or (b) actually incurred in a materially different amount for that class than for other classes. Advisory or custodial fees and other expenses related to management of the fund's assets may not be allocated differently among classes.

(c) The Rule expressly permits the waiver or reimbursement of class-specific expenses by the fund's investment adviser or underwriter and the ability to impose particular conversion features and exchange privileges on a class.

(d) The Rule's provisions on voting rights mandate that shareholders of a class have the right to vote on matters in which they have an interest and that only the interested class vote on class-specific matters.

(2) Accounting Matters

The Rule requires that income, realized and unrealized gains and losses and expenses of the fund not allocated to a particular class, must be allocated to each class on the basis of (1) the net assets of that class in relation to the net assets of the fund, (2) the so-called "simultaneous equations method," which is defined in the Rule, or (3) for money market funds and other daily dividend funds, the relative net assets of each class, excluding the value of subscriptions receivable.

(3) Board Responsibilities

The Rule imposes a number of responsibilities on a fund's board. The Rule requires that the board adopt for the fund a written plan setting forth the separate arrangement and expense allocation of each class and any related conversion features or exchange privileges. The fund's board, including a majority of the independent directors, is required to approve the plan before the issuance of multiple classes of shares and annually thereafter. In approving the plan, the board is required to make a finding that the plan was fair to, and in the best interests of, each class and the fund as a whole.

(4) A fund wishing to rely on Rule 18f-3 will have to comply with the SEC's rules on fund governance standards. See Rule 0-1(a)(7) under the 1940 Act.

c. Exemptive Relief

Prior to the adoption of Rule 18f-3, which is discussed above, the SEC granted many exemptive orders to permit the issuance of multiple classes. Because Rule 18f-3 was based on those exemptive orders, many of the requirements are the same, but the exemptive orders were more restrictive in several respects. Most funds now rely on Rule 18f-3. However, if a particular multiple class arrangement does not comply with Rule 18f-3, exemptive relief from the SEC should be considered.

D. Relative Advantages of Multiple Class and Master-Feeder Funds

1. Comparison

The multiple class and master-feeder structures each offer the same basic advantage over the traditional single tiered, single class mutual fund -- the ability to attract a broader range of investors through variation in shareholder services and charges, while also providing the economies of scale in portfolio management available to a larger fund. While sharing this common feature, each structure also offers certain advantages over the other.

2. Advantages of the Multiple Class Structure

a. The multiple class structure is somewhat less costly to establish and maintain than the master-feeder structure.

(1) The master-feeder structure requires establishment of new investment companies, each of which is required by the 1940 Act to commence operations with $100,000 in seed money.

(2) In the master-feeder structure, legal, auditing and certain fund administration expenses are incurred at both the master fund level and the feeder fund level.

b. Shareholder approval is normally not required to establish multiple classes unless corporate documents, which require shareholder approval to amend, must be amended to accommodate the multiple class structure. The master-feeder structure in contrast generally requires shareholder approval of changes in the fund's fundamental investment policies necessary for the conversion to master-feeder.

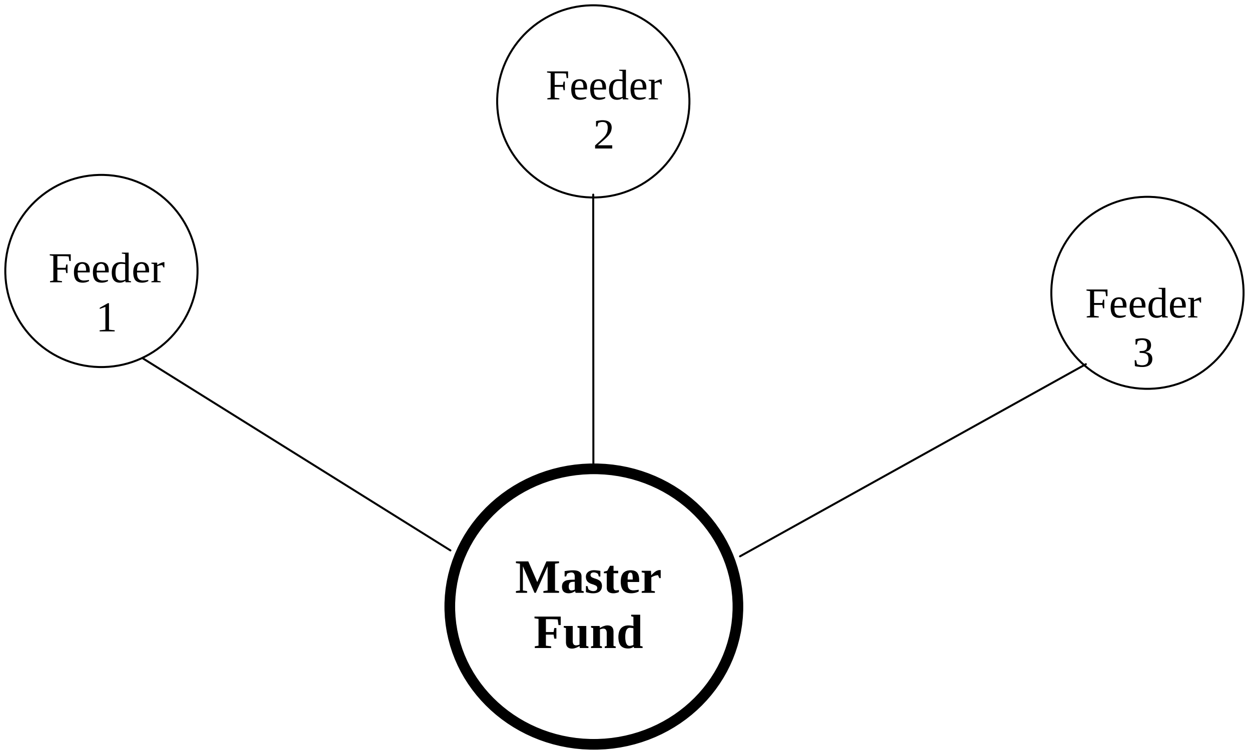
3. Advantages of the Master-Feeder Structure

a. Feeder funds investing in a common master fund may include feeder funds that are not registered under the 1933 and 1940 Acts, such as offshore funds and bank collective funds, thereby permitting increased potential assets in master funds and increased economies of scale.

b. No IRS or SEC position restricts the manner in which expenses and fees may vary among the feeder funds investing in a common master fund. For example, IRS positions restrict the ability of a fund administrator or investment adviser to waive fees or reimburse expenses to one class and not others, unless those fees are class-specific.

c. Because each feeder fund and the master fund are normally separate legal entities, each feeder fund may have a board composed of directors who do not serve on the board of any other feeder fund or on the board of the master fund. This feature may be attractive to distributors of proprietary funds who wish to maintain some level of control over their customers' assets.

MASTER-FEEDER FUND



MULTIPLE CLASS FUND